AUDIT & ACCOUNTING

GUIDE

NOVEMBER 1, 2016

Revenue Recognition

AICPA

A Resource of the
Enhancing Audit Quality Initiative

AICPA

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ISBN 978-1-94354-688-6

Preface

AICPA

A Resource of the Enhancing Audit Quality Initiative

(Updated as of November 1, 2016)

About AICPA Audit and Accounting Guides

This AICPA Audit and Accounting Guide has been developed by the AICPA and the Auditing Revenue Task Force, to assist management in the preparation of their financial statements in accordance with U.S. generally accepted accounting principles (GAAP) and to assist practitioners in performing and reporting on their audit engagements. Specifically, this guide is intended to help entities and auditors prepare for changes related to revenue recognition as a result of FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and subsequent ASUs amending FASB *Accounting Standards Codification* (ASC) 606.

AICPA guides may include sections at the end of individual chapters or following the last chapter, titled "Supplement." A supplement is a reproduction, in whole or in part, of authoritative guidance originally issued by a standard setting body (including regulatory bodies) and is applicable to entities or engagements within the purview of that standard setter, independent of the authoritative status of the applicable AICPA guide.

The Financial Reporting Executive Committee (FinREC) is the designated senior committee of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. The financial accounting and reporting guidance contained in the general accounting chapter has been reviewed by the Planning Subcommittee of FinREC.

This guide identifies certain requirements set forth in FASB ASC.

Accounting guidance for nongovernmental entities included in an AICPA Audit and Accounting Guide is a source of nonauthoritative accounting guidance. As discussed later in this preface, FASB ASC is the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC.

Auditing guidance related to generally accepted auditing standards (GAAS) included in an AICPA Guide is recognized as an interpretive publication as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing*

Standards (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of GAAS in specific circumstances, including engagements for entities in specialized industries.

Interpretive publications are issued under the authority of the AICPA Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether a proposed interpretive publication is consistent with GAAS. The ASB is the designated senior committee of the AICPA authorized to speak for the AICPA on all matters related to auditing. The members of the ASB have found the auditing guidance in this guide to be consistent with existing GAAS.

Although interpretive publications are not auditing standards, AU-C section 200 requires the auditor to consider applicable interpretive publications in planning and performing the audit because interpretive publications are relevant to the proper application of GAAS in specific circumstances. If the auditor does not apply the auditing guidance in an applicable interpretive publication, the auditor should document how the requirements of GAAS were complied with in the circumstances addressed by such auditing guidance.

Any auditing guidance in a guide appendix, though not authoritative, is considered an "other auditing publication." In applying such guidance, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. Although the auditor determines the relevance of other auditing guidance, auditing guidance in an appendix to a guide or a guide chapter has been reviewed by the AICPA audit and attest standards staff and the auditor may presume that it is appropriate.

Purpose and Applicability

Revenue recognition continues to pose significant audit risk to auditors. In May 2010, the Committee of Sponsoring Organizations of the Treadway Commission released *Fraudulent Financial Reporting: 1998-2007 An Analysis of U.S. Public Companies*. The report examines incidents of fraudulent financial reporting alleged by the SEC in accounting and auditing enforcement releases issued between January 1998 and December 2007. More than half of the incidents of fraud involved overstating revenues by recording them either fictitiously or prematurely. In the 2014 Association of Certified Fraud Examiners study, *Report to the Nations On Occupational Fraud and Abuse*, it was found that when financial statement fraud occurred, 61 percent of the cases involved revenue recognition.

The implications are wide reaching. Investor confidence has driven the unparalleled success of the U.S. capital markets, and a key component in creating that confidence is audited financial statements. In this guide, the AICPA's intent is to help auditors fulfill their professional responsibilities with regard to auditing management's assertions about revenue. This guide

- discusses the responsibilities of management, boards of directors, and audit committees for reliable financial reporting.
- summarizes key accounting guidance regarding whether and when revenue should be recognized in accordance with GAAP.
- identifies circumstances and transactions that may signal improper revenue recognition.

- summarizes key aspects of the auditor's responsibility to plan and perform an audit under GAAS.
- describes procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition.
- describes audit challenges that may be brought on by the changes in revenue recognition. Entities and auditors can benefit from advance planning for the conversion and for going forward under the requirements of the new revenue recognition standard.

The primary focus of this publication is revenue recognition for sales of goods and services in the ordinary course of business that fall within the scope of FASB ASC 606. The AICPA has formed 16 industry task forces to assist entities and auditors as they implement the requirements of the new revenue recognition standard. Future editions of this guide will address accounting and auditing implications of the 16 industry task forces, which are as follows:

- Aerospace and Defense
- Airlines
- Asset Management
- Broker-Dealers
- Construction Contractors
- Depository Institutions
- Gaming
- Health Care
- Hospitality
- Insurance
- Not-for-Profit
- Oil and Gas
- Power and Utility
- Software
- Telecommunications
- Timeshare

We encourage readers to visit the AICPA's Financial Reporting Center at www.aicpa.org/INTERESTAREAS/FRC/ACCOUNTINGFINANCIALREPORTING/REVENUERECOGNITION/Pages/RevenueRecognition.aspx to stay abreast on industry implementation issues as they move through a formal review process involving FinREC and FASB's Transition Resource Group, where necessary.

Recognition

The AICPA gratefully acknowledges those members of the following group that were instrumental in developing the general auditing guidance in this guide:

AICPA *Auditing Revenue Task Force*: Lynford Graham (chair), Steve Bodine, Rob Chevalier, Jacob Gatlin, Adam Hallemeyer, Marie Kish,

Sean Lager, Bruce Nunnally, Keith Peterka, Daniel Sanders, Julie Schlendorf, Elizabeth Sloan, Amy Steele, and Jeff Wilks.

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Guidance Considered in This Edition

Authoritative guidance issued through November 1, 2016, has been considered in the development of this edition of the guide. However, this guide does not include all audit, accounting, reporting, and other requirements applicable to an entity or a particular engagement. This guide is intended to be used in conjunction with all applicable sources of authoritative guidance.

In updating this guide, all guidance issued up to and including the following was considered, but not necessarily incorporated, as determined based on applicability:

- FASB ASU No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments (a consensus of the FASB Emerging Issues Task Force)*
- Statement on Auditing Standards (SAS) No. 131, *Amendment to Statement on Auditing Standards No. 122 Section 700*, Forming an Opinion and Reporting on Financial Statements (AICPA, *Professional Standards*, AU-C sec. 700)
- Interpretation No. 3, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and International Standards on Auditing," of AU-C section 700 (AICPA, *Professional Standards*, AU-C sec. 9700 par. .08–.13)
- FASB IASB Transition Resource Group for Revenue Recognition, *Agenda Ref. 55—April 2016 Meeting—Summary of Issues Discussed and Next Steps*

Users of this guide should consider guidance issued subsequent to those items listed previously to determine its effect, if any, on entities and engagements covered by this guide. In determining the applicability of recently issued guidance, readers should also consider its effective date.

FASB ASC Pending Content

Presentation of Pending Content in FASB ASC

Amendments to FASB ASC (issued in the form of ASUs) are initially incorporated into FASB ASC in "pending content" boxes below the paragraphs being amended with links to the transition information. The pending content boxes are meant to provide users with information about how the guidance in a paragraph will change as a result of the new guidance.

Pending content applies to different entities at different times due to varying fiscal year-ends, and because certain guidance may be effective on different dates for public and nonpublic entities. As such, FASB maintains amended guidance in pending content boxes within FASB ASC until the roll-off date. Generally, the roll-off date is six months following the latest fiscal year end for which the original guidance being amended could still be applied.

Presentation of FASB ASC Pending Content in AICPA Audit and Accounting Guides

Amended FASB ASC guidance that is included in pending content boxes in FASB ASC on the as of date of the guide are typically referenced as "pending content" throughout the guide. Pending content will eventually be subjected to FASB's roll-off process and no longer be labeled as "pending content" in FASB ASC (as discussed in the previous paragraph).

Terms Used to Define Professional Requirements in This AICPA Audit and Accounting Guide

Any requirements described in this guide are normally referenced to the applicable standards or regulations from which they are derived. Generally the terms used in this guide describing the professional requirements of the referenced standard setter (for example, the ASB) are the same as those used in the applicable standards or regulations (for example, *must* or *should*). However, where the accounting requirements are derived from FASB ASC, this guide uses *should*, whereas FASB uses *shall*. In its resource document "About the Codification" that accompanies FASB ASC, FASB states that it considers the terms *should* and *shall* to be comparable terms and to represent the same concept—the requirement to apply a standard.

Readers should refer to the applicable standards and regulations for more information on the requirements imposed by the use of the various terms used to define professional requirements in the context of the standards and regulations in which they appear.

Certain exceptions apply to these general rules, particularly in those circumstances for which the guide describes prevailing or preferred industry practices for the application of a standard or regulation. In these circumstances, the applicable senior committee responsible for reviewing the guide's content believes the guidance contained herein is appropriate for the circumstances.

Applicability of Generally Accepted Auditing Standards and PCAOB Standards

Appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of the AICPA Code of Professional Conduct recognizes both the ASB and the PCAOB as standard setting bodies designated to promulgate auditing, attestation, and quality control standards. Paragraph .01 of the "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET sec. 1.310.001 and 2.310.001) requires an AICPA member who performs an audit to comply with the applicable standards.

Audits of the financial statements of those entities not subject to the oversight authority of the PCAOB (that is, those entities whose audits are not within the PCAOB's jurisdiction—hereinafter referred to as *nonissuers*[1]) are to be conducted in accordance with GAAS as issued by the ASB. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs and their related interpretations are codified in AICPA *Professional Standards*. In citing GAAS and their related interpretations, references generally use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate.

Audits of the financial statements of those entities subject to the oversight authority of the PCAOB (that is, those entities whose audits are within the

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[1] For audits of SEC-registered broker-dealers, both issuer and nonissuer, only PCAOB auditing standards apply. The Dodd-Frank Act amended the Sarbanes-Oxley Act of 2002 to give the PCAOB full oversight authority over audits of all broker-dealers (including nonissuers), which includes standard setting, inspection, and enforcement.

PCAOB's jurisdiction—hereinafter referred to as *issuers*) are to be conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002. The SEC has oversight authority over the PCAOB, including the approval of its rules, standards, and budget. In citing the auditing standards of the PCAOB, references generally use section numbers within the reorganized PCAOB auditing standards and not the original standard number, as appropriate.

The auditing content in this guide primarily discusses GAAS issued by the ASB and is applicable to audits of nonissuers. Users of this guide may find the tool developed by the PCAOB's Office of the Chief Auditor helpful in identifying comparable PCAOB standards. The tool is available at http://pcaobus.org/Standards/Auditing/Pages/FindAnalogousStandards.aspx.

Considerations for audits of issuers in accordance with PCAOB standards may also be discussed within this guide's chapters. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Audits Performed in Accordance With PCAOB Standards*.

Applicability of Quality Control Standards

QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. A system of quality control consists of policies that a firm establishes and maintains to provide it with reasonable assurance that the firm and its personnel comply with professional standards, as well as applicable legal and regulatory requirements. The policies also provide the firm with reasonable assurance that reports issued by the firm are appropriate in the circumstances. This section applies to all CPA firms with respect to engagements in their accounting and auditing practice.

AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), addresses the auditor's specific responsibilities regarding quality control procedures for an audit of financial statements. When applicable, it also addresses the responsibilities of the engagement quality control reviewer.

Because of the importance of audit quality, we have added a new appendix, appendix A, "Overview of Statements on Quality Control Standards," to this guide. Appendix A summarizes key aspects of the quality control standard. This summarization should be read in conjunction with QC section 10, AU-C section 220, and the quality control standards issued by the PCAOB, as applicable.

Alternatives Within U.S. Generally Accepted Accounting Principles

The Private Company Council (PCC), established by the Financial Accounting Foundation's Board of Trustees in 2012, and FASB, working jointly, will mutually agree on a set of criteria to decide whether and when alternatives within U.S. GAAP are warranted for private companies. Based on those criteria, the PCC reviews and proposes alternatives within U.S. GAAP to address the needs of users of private company financial statements. These U.S. GAAP alternatives may be applied to those entities that are not public business entities, not-for-profits, or employee benefit plans.

The FASB ASC master glossary defines a public business entity as follows:

> A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.
>
> a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
>
> b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
>
> c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
>
> d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
>
> e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.
>
> An entity may meet the definition of a public business entity solely because its financial information or financial statements are included in another entity's filing with the SEC. In that case, the entity is a public business entity only for purposes of financial statements that are filed or furnished with the SEC.

Considerations related to alternatives for private companies may be discussed within this guide's chapters. When such discussion is provided, the related paragraphs are designated with the following title: *Considerations for Private Companies That Elect to Use Standards as Issued by the Private Company Council*.

AICPA.org Website

We encourage you to visit the AICPA website at www.aicpa.org, and the Financial Reporting Center at www.aicpa.org/FRC. The Financial Reporting Center supports members in the execution of high-quality financial reporting. Whether you are a financial statement preparer or a member in public practice, this center provides exclusive member-only resources for the entire financial reporting process, and provides timely and relevant news, guidance and examples supporting the financial reporting process, including accounting, preparing financial statements, and performing compilation, review, audit, attest, or assurance and advisory engagements. Certain content on the AICPA's websites referenced in this guide may be available only to AICPA members.

Select Recent Developments Significant to This Guide

AICPA's Ethics Codification Project

The AICPA's Professional Ethics Executive Committee (PEEC) restructured and codified the AICPA Code of Professional Conduct (code) so that members and other users of the code can apply the rules and reach appropriate conclusions more easily and intuitively. This is referred to as the AICPA Ethics Codification Project.

Although PEEC believes it was able to maintain the substance of the existing AICPA ethics standards through this process and limited substantive changes to certain specific areas that were in need of revision, the numeric citations and titles of interpretations have all changed. In addition, the ethics rulings are no longer in a question and answer format but rather, have been drafted as interpretations, incorporated into interpretations as examples, or deleted where deemed appropriate. Following are some examples:

- Rule 101, *Independence* [ET sec. 101 par. .01] is referred to as the "Independence Rule" [ET sec. 1.200.001] in the revised code.
- the content from the ethics ruling entitled "Financial Services Company Client has Custody of a Member's Assets" [ET sec. 191 par. .081–.082] is incorporated into the "Brokerage and Other Accounts" interpretation [ET sec. 1.255.020] found under the subtopic "Depository, Brokerage, and Other Accounts" [ET sec. 1.255] of the "Independence" topic [ET sec. 1.200].

The revised code was effective December 15, 2014 and is available at http://pub.aicpa.org/codeofconduct/Ethics.aspx. References to the code have been updated in this guide. To assist users in locating in the revised code content from the prior code, PEEC created a mapping document. The mapping document is available in Excel format in appendix D in the revised code.

Attestation Clarity Project

To address concerns over the clarity, length, and complexity of its standards, the ASB established clarity drafting conventions and undertook a project to redraft all the standards it issues in clarity format. The redrafting of Statements on Standards for Attestation Engagements (SSAEs or attestation standards) in SSAE No. 18, *Attestation Standards: Clarification and Recodification* (AICPA, *Professional Standards*), represents the culmination of that process.

The attestation standards are developed and issued in the form of SSAEs and are codified into sections in AICPA *Professional Standards*. SSAE No. 18 uses the identifier "AT-C" to differentiate the clarified attestation standards from the pre-clarity "AT" sections that are superseded by SSAE No. 18.

The AT sections in AICPA *Professional Standards* remain effective through April 2017, by which time substantially all engagements for which the AT sections were still effective are expected to be completed.

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Chapter 1

General Accounting Considerations

Notice to readers: This chapter provides an overview of FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers.* Readers are encouraged to refer to FASB ASC 606 for the full text, implementation guidance, and illustrations.

Due to the effective date of FASB ASC 606, any references to this topic are identified as pending content within FASB ASC, although not designated as such in this guide. Refer to the guide's preface for more information on pending content.

Lastly, fasb.org has information on activities from the FASB/IASB Joint Transition Resource Group for Revenue Recognition, including summaries of issues discussed.

Introduction

1.01 In May 2014, FASB and IASB issued a joint accounting standard on revenue recognition to address a number of concerns surrounding the inconsistencies and complexities in accounting for revenue transactions. FASB issued the update in the form of FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, and the IASB issued International Financial Reporting Standards (IFRS) 15, *Revenue from Contracts with Customers*. FASB ASU No. 2014-09 amended the FASB ASC by creating Topic 606, *Revenue from Contracts with Customers*, and amending Subtopic 340-40, *Other Assets and Deferred Costs—Contracts with Customers*. The guidance in this update supersedes revenue recognition requirements in FASB ASC 605, *Revenue Recognition*, along with most of the revenue recognition guidance under the 900 series of industry-specific topics. IFRS 15 will replace International Accounting Standard (IAS) 11, *Construction Contracts,* and IAS 18, *Revenue*.

1.02 As part of the boards' efforts to converge U.S. generally accepted accounting principles (U.S. GAAP) and IFRS, FASB ASC 606 eliminates the transaction- and industry-specific revenue recognition guidance under current U.S. GAAP and replaces it with a principles-based approach for revenue recognition.

1.03 FASB ASC 606-10-15-2 explains that FASB ASC 606 should be applied by entities to all contracts with customers except for a specific list of exceptions. These exceptions include contracts that are within the scope of other standards (for example, insurance contracts or lease contracts), financial instruments, guarantees (other than product or service warranties), and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.

Authoritative Status and Effective Date

1.04 The guidance in FASB ASC 606 was originally effective for annual reporting periods of public entities[1] beginning on or after December 15, 2016, including interim periods within that reporting period. Early application was not permitted for public entities. For all other entities, the guidance in the new standard was originally effective for annual reporting periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018.

1.05 To allow entities additional time to implement systems, gather data, and resolve implementation questions, FASB issued ASU No. 2015-14, *Revenue From Contracts with Customers: Deferral of the Effective Date*, in August 2015, to defer the effective date of FASB ASU No. 2014-09 for one year.

1.06 As a result of this deferral, public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in FASB ASU No. 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application would be permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

1.07 All other entities should apply the guidance in FASB ASU No. 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. Application would be permitted earlier only as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period, or an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which an entity first applies the guidance in FASB ASU No. 2014-09.

1.08 The IASB issued an amendment to IFRS 15 deferring the effective date by one year to 2018. The publication of the amendment, *Effective Date of IFRS 15*, follows from the IASB's decision in July 2015 to defer the effective date from January 1, 2017, to January 1, 2018, having considered the feedback to its consultation. Companies applying IFRS continue to have the option to apply the standard early.

Transitioning to the New Standard

1.09 FASB ASC 606-10-65-1 allows entities two options when transitioning to the guidance under FASB ASC 606. FASB ASC 606-10-65-1(d)1 explains that the first option is full retrospective application of the new standard, which requires reflecting the cumulative effect of the change in all contracts on the opening retained earnings of the earliest period presented and adjusting the financial statements for each prior period presented to reflect the effect of applying the new accounting standard. Retrospective application would be applied

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[1] A *public entity* is an entity that is any one of the following:

1. A public business entity
2. A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
3. An employee benefit plan that files or furnishes financial statements to the SEC.

to interim periods, as well as annual periods presented. As stated in FASB ASC 606-10-65-1(f), an entity following the full retrospective approach may elect any of the following practical expedients, applied consistently to all contracts:

- For completed contracts, an entity does not need to restate contracts that begin and are completed within the same annual reporting period.
- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
- For all reporting periods presented before the date of initial application, an entity does not need to disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.
- For contracts that were modified before the beginning of the earliest reporting period, an entity does not need to retrospectively restate the contract for those contract modifications in accordance with paragraphs 12–13 of FASB ASC 606-10-25. Instead, an entity should reflect the aggregate effect of all modifications that occur before the beginning of the earliest period presented when
  - — identifying the satisfied and unsatisfied performance obligations,
  - — determining the transaction price, and
  - — allocating the transaction price to the satisfied and unsatisfied performance obligations.

1.10 As an alternative, under FASB ASC 606-10-65-1(d)2, entities may apply the amendments to the new standard retrospectively with the cumulative effect of initially applying the amendments recognized at the date of initial application. Under this transition method, an entity should elect to apply this guidance retrospectively either to all contracts at the date of initial application or only to contracts that are not completed contracts at the date of initial application. An entity should disclose whether it has applied this guidance to all contracts at the date of initial application or only to contracts that are not completed at the date of initial application.

1.11 When using the cumulative effect method described in paragraph 1.10, the entity should provide additional disclosures of the following, in reporting periods that include the date of initial application:

- The amount by which each financial statement line item is affected in the current reporting period by the application of the new standard as compared to the guidance that was in effect before the change
- An explanation of the reasons for significant changes

1.12 Both application methods include recording the direct effects of the change in accounting principle. Indirect effects that would have been recognized if the newly adopted accounting principles had been followed in prior periods would not be included in the retrospective application. FASB ASC 250-10-45-8 defines direct effects of a change in accounting principle as "those recognized changes in assets or liabilities necessary to effect a change in accounting principle." An example of a direct effect described in this section of FASB ASC 250 is an adjustment to an inventory balance to effect a change in inventory valuation method. Indirect effects are defined within FASB ASC 250-10-20 as "any changes to current or future cash flows of an entity that result from making a change in accounting principle that is applied retrospectively." An example of an indirect change is a change in royalty payments based on a reported amount such as revenue or net income.

Post-Standard Activity

1.13 To assist with implementation of the new standard, FASB and the IASB announced the formation of the Joint Transition Resource Group (TRG) for Revenue Recognition in June 2014. The objective of this group is to keep the boards informed of potential implementation issues that may arise as entities implement the new guidance. Members of the TRG include financial statement preparers, auditors, and financial statement users representing various industries, geographies, and public and private companies. Any stakeholder may submit a potential implementation issue for discussion at TRG meetings, to be evaluated and prioritized for further discussion by each board.

1.14 As of the date of this publication, the TRG had held two meetings in 2014, four in 2015, and two in 2016. A submission tracker is available on the TRG website at fasb.org that includes a listing of all revenue recognition implementation issues submitted and the current status of these issues.

1.15 In addition to advising the boards to defer the effective date, the TRG informed the boards that technical corrections were needed to further articulate the guidance in the standard.[2] As a result, FASB has issued the following accounting updates subsequent to FASB ASU No. 2014-09:

a. FASB ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*

b. FASB ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*

c. FASB ASU No. 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting*

d. FASB ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

Overview of FASB ASU No. 2014-09, *Revenue from Contracts with Customers*

1.16 As stated in FASB ASC 606-10-05-3, the core principle of FASB ASC 606 is that an entity should recognize revenue to depict the transfer of goods

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[2] FASB has also exposed several proposed accounting standards updates for technical corrections related to revenue recognition. FASB is expected to finalize the technical corrections during the fourth quarter of 2016.

or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

1.17 To recognize revenue under the new framework, FASB ASC 606-10-05-4 states that an entity should follow these five steps:

a. Step 1—Identify the contract(s) with a customer.

b. Step 2—Identify the performance obligations in the contract.

c. Step 3—Determine the transaction price.

d. Step 4—Allocate the transaction price to the performance obligations in the contract.

e. Step 5—Recognize revenue when (or as) the entity satisfies a performance obligation.

Step 1: Identify the Contract with a Customer

1.18 FASB ASC 606-10-25-2 defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." FASB ASC 606-10-25-1 states an entity should account for a contract with a customer that is within the scope of FASB ASC 606 when all of the following criteria are met:

a. It has the approval and commitment of the parties.

b. Rights of the parties are identified.

c. Payment terms are identified.

d. The contract has commercial substance.

e. Collectibility of substantially all of the consideration is probable.

1.19 Paragraphs 1–8 of FASB ASC 606-10-25 provide guidance on identifying the contract with a customer. Paragraphs 3A–3C of FASB ASC 606-10-55 provide guidance for assessing the collectibility of consideration as required in FASB ASC 606-10-25-1e.

1.20 FASB ASC 606-10-25-9 provides guidance on when multiple contracts should be combined under FASB ASC 606. Paragraphs 10–13 of FASB ASC 606-10-25 provide guidance on accounting for contract modifications.

Step 2: Identify the Performance Obligations in the Contract

1.21 An entity should assess the goods or services promised in a contract with a customer at contract inception. Each promise to transfer one of the following to the customer is considered a performance obligation, in accordance with FASB ASC 606-10-25-14:

a. A good or service (or bundle of goods or services) that is distinct

b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer

1.22 Paragraphs 15–18B of FASB ASC 606-10-25 provide guidance on how to determine a series of distinct goods or services and explicit and implicit promises to customers, and how to account for immaterial promised goods or services, and shipping and handling activities.

1.23 FASB ASC 606-10-19 explains that a good or service that is promised to a customer is distinct if both of the following criteria are met:

a. **Capable of being distinct**. The customer can benefit from a good or service either on its own or together with other resources that are readily available to the customer.

b. **Distinct within the context of the contract**. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

1.24 Paragraphs 20–22 of FASB ASC 606-10-25 provide guidance on determining if a promised good or service is distinct, and combining promised goods or services until an entity identifies a bundle of goods or services that is distinct.

Step 3: Determine the Transaction Price

1.25 FASB ASC 606-10-32-2 explains that the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

1.26 FASB ASC 606-10-32-3 explains that when determining the transaction price, an entity should consider the effects of all of the following:

a. Variable consideration (paragraphs 5–10 of FASB ASC 606-10-32 and 606-10-32-14)

b. Constraining estimates of variable consideration (paragraphs 11–13 of FASB ASC 606-10-32)

c. The existence of a significant financing component (paragraphs 15–20 of FASB ASC 606-10-32)

d. Noncash considerations (paragraphs 21–24 of FASB ASC 606-10-32)

e. Consideration payable to the customer (paragraphs 25–27 of FASB ASC 606-10-32).

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

1.27 FASB ASC 606-10-32-28 explains that the objective when allocating the transaction price is for an entity to allocate the transaction price to each separate performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

1.28 FASB ASC 606-10-32-29 explains that an entity should generally allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis.

1.29 Paragraphs 31–35 of FASB ASC 606-10-32 provide guidance on allocation of the transaction price based on stand-alone selling prices. Paragraphs 36–38 of FASB ASC 606-10-32 provide guidance on allocation of a discount. Paragraphs 39–41 of FASB ASC 606-10-32 provide guidance on allocation of variable consideration. Paragraphs 42–45 of FASB ASC 606-10-32 provide guidance on changes in the transaction price.

Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

1.30 The requirements of FASB ASC 606-10-25-23 state that an entity should recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

1.31 As stated in FASB ASC 606-10-25-25, control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.

1.32 For each performance obligation identified in accordance with paragraphs 14–22 of FASB ASC 606-10-25, paragraph 24 states that an entity should determine at contract inception whether it satisfies the performance obligation over time (in accordance with paragraphs 27–29 of FASB ASC 606-10-25) or at a point in time (in accordance with FASB ASC 606-10-25-30). If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

1.33 Paragraphs 27–29 of FASB ASC 606-10-25 provide guidance for determining if an entity transfers control of a good or service over time. Paragraphs 31–37 of FASB ASC 606-10-25 provide guidance for measuring progress toward complete satisfaction of a performance obligation, methods for measuring progress and reasonable measures of progress. FASB ASC 606-10-25-30 provides indicators of the transfer of control for performance obligations satisfied at a point in time.

Costs to Obtain or Fulfill a Contract With a Customer

Incremental Costs of Obtaining a Contract

1.34 As stated in FASB ASC 340-40-25-1, "an entity should recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs." FASB ASC 340-40-25-2 explains that the incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission). FASB ASC 340-40-25-3 further explains that costs to obtain a contract that would have been incurred regardless of whether the contract was obtained should be recognized as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

1.35 FASB ASC 340-40-25-4 allows for a practical expedient, stating that an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

Costs of Fulfilling a Contract

1.36 FASB ASC 340-40-25-5 requires an entity to recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).

b. The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.

c. The costs are expected to be recovered.

1.37 FASB ASC 340-40-25-6 explains that for costs incurred in fulfilling a contract with a customer that are within the scope of another topic (for example, FASB ASC 330, *Inventory*; or FASB ASC 360, *Property, Plant, and Equipment*), an entity should account for those costs in accordance with guidance in those topics or subtopics.

1.38 Paragraphs 7–8 of FASB ASC 340-40-25 provide guidance on identifying whether costs relate directly to a contract or should be expensed when incurred. Paragraphs 1–6 of FASB ASC 340-40-35 provide guidance on amortization and impairment of assets recognized in accordance with paragraph 1 or 5 of ASC 340-40-25.

Disclosures

1.39 There are significant disclosure requirements in FASB ASC 606. FASB ASC 606-10-50-1 explains that the objective of the disclosure requirements is to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers, and to achieve that objective an entity should disclose qualitative and quantitative information about the following:

a. Contracts with customers—including revenue recognized, disaggregation of revenue, and information about contract balances and performance obligations (including the transaction price allocated to the remaining performance obligations)

b. Significant judgments and changes in judgments affecting the amount of revenue and assets recognized—determining the timing of satisfaction of performance obligations (over time or at a point in time), and determining the transaction price and amounts allocated to performance obligations.

1.40 Paragraphs 1–23 of FASB ASC 606-10-50 and paragraphs 1–6 of FASB ASC 340-40-50 provide guidance on required disclosures and practical expedients. Paragraphs 89–91 of FASB ASC 606-10-55 provide considerations for disclosure of disaggregated revenue.

Other Topics

Presentation of Contract With a Customer

1.41 Paragraphs 1–5 of FASB ASC 606-10-45 provide guidance for determining presentation of the contract with a customer in the statement of financial position as a contract asset, a receivable or a contract liability.

Sale With a Right of Return

1.42 Paragraphs 22–29 of FASB ASC 606-10-55 provide guidance for accounting for sales with a right of return.

Warranties

1.43 Paragraphs 30–35 of FASB ASC 606-10-55 provide guidance on accounting for warranties.

Principal versus Agent

1.44 Paragraphs 36–40 of FASB ASC 606-10-55 provide considerations for determining whether an entity is a principal or an agent in a contract with customers.

Customer Options for Additional Goods or Service—Material Rights

1.45 Paragraphs 41–45 of FASB ASC 606-10-55 provide guidance for accounting for customer options to acquire additional goods or services and material rights to the customer.

Customer's Unexercised Rights

1.46 Paragraphs 46–49 of FASB ASC 606-10-55 provide guidance for accounting for customer's unexercised rights.

Nonrefundable Upfront Fees

1.47 Paragraphs 50–53 of FASB ASC 606-10-55 provide guidance for accounting for nonrefundable upfront fees.

Licensing

1.48 Paragraphs 54–60 and 62–65B of FASB ASC 606-10-55 provide guidance for accounting for licenses of intellectual property.

Repurchase Agreements

1.49 Paragraphs 66–78 of FASB ASC 606-10-55 provide guidance for accounting for repurchase agreements.

Consignment Arrangements

1.50 Paragraphs 79–80 of FASB ASC 606-10-55 provide guidance for determining whether an arrangement is a consignment arrangement and the related accounting.

Bill-and-Hold Arrangements

1.51 Paragraphs 81–84 of FASB ASC 606-10-55 provide guidance for accounting for bill-and-hold arrangements.

Customer Acceptance

1.52 Paragraphs 85–88 of FASB ASC 606-10-55 provide guidance for evaluating customer acceptance of an asset.

Chapter 2

General Auditing Considerations

Introduction

> ***Notice to readers:*** This chapter of the guide begins with an overview of some important audit considerations in the context of the five-step process of FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*. A section entitled "General Audit Considerations Over Revenue Recognition" relates broad auditing guidance that may have relevance under either FASB ASC 605, *Revenue Recognition*, or FASB ASC 606. The chapter then goes through the audit process as it relates to FASB ASC 606, noting relevant audit considerations at the risk assessment, performance, and evaluation phases of the audit. An initial review of this chapter's entries in the table of contents may help the auditor more specifically identify topics of interest. Some topics that have importance during different phases of the audit, such as fraud, may be discussed in the context of each of those phases.

2.01 This chapter helps you plan and perform your audits. Auditors[1] should consider this chapter as an aid in identifying the significant auditing considerations relevant to FASB ASC 606, *Revenue from Contracts with Customers*, and subsequent updates to FASB ASC 606 so that sufficient appropriate evidence is available to auditors. Note that the new standard does not apply to all revenue transactions, but only those involving contracts with customers. The information in this chapter can help you identify the risks of material misstatement[2] that may arise from revenue recognition issues, including significant risks requiring special audit consideration.

2.02 Revenue is critically important in the financial statements of entities, and revenue recognition is frequently cited in financial reporting frauds. Thus, revenue recognition remains a priority for regulators and the accounting profession. Implementing FASB ASC 606 will likely be the most significant and comprehensive change for most entities and their auditors in many years. This guide encompasses audit requirements to obtain evidence regarding the recognition of revenues, required initial disclosures, and balances.

2.03 Revenue is generally the largest single income statement line item and sometimes the largest account included in an entity's financial statements, and issues involving revenue recognition are often among the more significant issues that financial statement preparers and auditors face. Many challenges exist in accounting for revenue transactions under FASB ASC 606, including (1) determining whether, when, and how to recognize revenue based on the new

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[1] Paragraph .27 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Entities may also find information in this guide useful in understanding the evidence auditors are likely to be seeking to support management's transition to FASB *Accounting Standards Codification* (ASC) 606, *Revenue from Contracts with Customers*.

[2] *Risk of material misstatement* is a defined term meaning the combination of inherent and control risk (paragraph .14 of AU-C section 200).

authoritative accounting standards and (2) ensuring all the facts surrounding a particular, often unique, transaction are known and have been considered because the accounting conclusions can be significantly affected by these facts. The core objective of auditing revenue lies in obtaining reasonable assurance that the underlying accounting for a transaction is consistent with generally accepted accounting principles (GAAP) (the relevant revenue recognition standards), in the context of auditing the financial statements as a whole. Thus, the first step for all entities and their auditors is comprehending and understanding the accounting requirements as applied in the specific circumstances of the entity. A key element of FASB ASC 606 is its applicability to all entities in all industries, in lieu of the previous industry-specific revenue recognition guidance. Other standards may address specific related issues, such as lease contracts, guarantees (except product or service warranties), nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers, financial instruments, or specific industry guidance.

2.04 Refer to chapter 1, "General Accounting Considerations," of this guide for a high level summary of FASB ASC 606. This chapter provides selected observations regarding auditing issues that can arise during each of the five steps of the framework in FASB ASC 606. This guide continues with a series of topical auditing subjects that expand on how these subjects are likely to be affected by FASB ASC 606. It is important to note that there are many instances where estimates and judgments will be critical to revenue recognition. Entities and auditors will likely experience challenges producing and evaluating evidence that supports the assertions about the resulting values and disclosures.

2.05 As previously covered in chapter 1 of this guide, the guidance in FASB ASC 606 should be applied starting with annual reporting periods beginning after December 15, 2017, for public entities,[3] and December 15, 2018, for all other entities. Until then, or upon an entity's early adoption of FASB ASC 606, the existing guidance applicable to revenue recognition remains relevant, including the guidance provided in AICPA Audit Guide *Auditing Revenue in Certain Industries*.

Auditing the Five-Step Model of FASB ASC 606

2.06 This section describes audit issues that may arise under the five-step model. Italicized text in this section is from FASB ASC 606.

2.07 FASB ASC 606-10-05-4 outlines the five steps for recognizing revenue under FASB ASC 606 as follows:

1. Identify the contract(s) with a customer.
2. Identify the performance obligation(s) in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligation(s) in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

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[3] These entities include not-for-profit entities with conduit debt and 11-K reporting entities.

Step 1: Identify the Contract(s) With a Customer

2.08 To apply the new model, an entity should first identify the contract, or contracts, to provide goods and services to customers. Contracts with customers in the scope of FASB ASC 606 that create enforceable rights and obligations and meet the criteria under FASB ASC 606-10-25-1 are accounted for in accordance with the new guidance. FASB ASC 606-10-25-1 provides criteria that a contract with a customer should meet to be accounted for under the new model. These criteria may differ significantly from current practice. The form of the contract may be written, verbal, or implied by customary business practices but should be enforceable and have commercial substance. An entity should consider all relevant facts and circumstances when assessing whether an arrangement meets the definition of a contract under FASB ASC 606-10-25-1. For example, a purchase order may represent a contract under FASB ASC 606 for one entity, but a different entity may need to consider a purchase order in tandem with a separate executed master agreement on which to base its revenue recognition assessment. The answer will usually depend on facts and circumstances that may vary from entity to entity and transactions within an entity.

2.09 The practices and processes for establishing contracts with customers can vary across legal jurisdictions, industries, and entities. In many cases, an entity considers those practices and processes when determining whether an agreement creates enforceable rights and obligations of the entity. Expert legal advice may be necessary to determine whether a contract is legally enforceable, especially for oral or "implicit" contracts. In addition, it may be difficult to identify the jurisdiction over a contract that spans various states or nations in international commerce. In many cases, auditors obtain evidence from management in order to conclude whether the contract is legally enforceable and has an enforceable right to payment. Accounting management and auditors may need to involve legal resources to make this assessment.

2.10 Some issues for management and their auditors to consider are the following:

a. *The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.* When the contract is oral or implied, audit procedures under paragraph .06 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), are still required to be performed in order to obtain evidence regarding the terms of the agreement. Management may need to develop a policy to reflect the approval requirements for their contract types. Management's policy may differ from revenue stream to revenue stream and contract to contract depending on the relevant facts and circumstances when assessing whether the parties intend to be bound by the contract. Also, depending on legal requirements, a written contract may not be required even if one is used, and the entity will ordinarily account for an arrangement as soon as performance begins rather than when the contract is signed. Evidence of contract approval may include confirmation with the customer regarding the date it approved the contract. FASB ASC 606-10-25-2 requires entities to consider all relevant facts and circumstances to assess whether the parties are committed to perform their respective obligations under, and intend to be bound by, the terms of the contract. Management's commitment may be all or less than all of the rights and obligations to be fulfilled. Entities will need to provide auditors with sufficient and appropriate evidence[4] to be able to conclude that the parties are substantially committed to the contract. Auditors evaluate this evidence (both positive and negative) and possibly the effectiveness of management's controls in this area.

b. *The entity can identify each party's rights regarding the goods or services to be transferred.* Entities should objectively identify both explicit and implicit rights contained in the contract. For example, an entity's past practices might indicate that it implicitly offers a general right of return to its customers. Accordingly, management may conclude, based on its historical evidence, that a specific customer contract contains a general right of return even if the contract says otherwise or is silent. In addition, entities will potentially need to discern any substantive versus nonsubstantive rights. Auditors will ordinarily need to assess those management conclusions regarding explicit and implicit rights.

c. *The entity can identify the payment terms for the goods or services to be transferred.* In a significant change from current practice, identifying the payment terms does not require that the transaction price be fixed or stated in the contract with the customer. Provided there is an enforceable right to payment (as a matter of law) and the contract contains sufficient information to enable the entity to estimate the transaction price, the contract is likely to qualify for revenue recognition under the new model (assuming all other criteria for accounting for a contract with a customer are met). If there is significant uncertainty in the risk, timing, or amount of the entity's future cash flows as a result of the terms of the contract, auditing the assumptions surrounding estimated revenue becomes more challenging.

d. *The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).* Determining whether an arrangement has commercial substance for the purposes of FASB ASC 606 is consistent with the commercial substance determination elsewhere in U.S. GAAP. However, this determination can require significant judgment. Legal issues may be involved in certain contracts. Auditors may need to consult legal resources to resolve complex issues. Inquiries combined with other evidence and representations may be necessary to provide sufficient and appropriate audit evidence.

e. *It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer. In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if*

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[4] Refer to paragraph .05 of AU-C section 500, *Audit Evidence* (AICPA, *Professional Standards*), for the definitions of the terms *appropriateness (of audit evidence)* and *sufficiency (of audit evidence).*

the consideration is variable because the entity may offer the customer a price concession (see FASB ASC 606-10-32-7). FASB ASC 606-10-25-5 notes that an entity should evaluate at contract inception (and again when significant facts and circumstances change) whether it is probable that the entity will collect substantially all of the consideration to which it expects to be entitled in exchange for transferring goods or services to a customer. The term *probable* is defined consistently within existing U.S. GAAP as "likely to occur." Significant judgment will often be involved in a collectibility assessment at contract initiation. Such assessment under FASB ASC 606 is based on the amount to which the entity expects to be entitled (that is, the transaction price) and not the stated contract price. The transaction price may be less than the contract price, such as when the entity intends to offer a price concession. The entity will likely need to involve those within the organization responsible for initiation of contracts and evaluation of credit risk when assessing collectibility. In many cases, collectibility is difficult to objectively assess, especially at the inception of the contract. Auditors will ordinarily look to obtain and test evidence in accordance with the guidance in AU-C section 500 and AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*), as appropriate, when evaluating an entity's assertions around the collectibility of consideration to which the entity is entitled. In addition, evidence of a customer's intent and ability to pay, or about the intent to offer price or service concessions will ordinarily need to be gathered.

i. The transaction price is equal to the amount to which the entity expects to be entitled, not the amount that the entity expects to receive (therefore, without regard to collection risk). The transaction price is not adjusted for customer credit risk; instead, impairments to receivables will be separately presented as an expense. If collectibility is not considered probable, a contract does not exist.[5] As explained in FASB ASC 606-10-55-3C, when assessing whether a contract meets the criteria in 606-10-25-1(e), it is necessary to determine whether the contractual terms and its customary business practices indicate that the entity's exposure to credit risk is less than the entire consideration promised in the contract because the entity has the ability to mitigate its credit risk. The collectibility assessment in FASB ASC 606-10-25-1(e) requires judgment and consideration of all the facts and circumstances, including the entity's customary business practices and its knowledge of the customer, in determining whether it is probable that the entity will collect substantially all of the consideration to which it expects to be entitled.

ii. Collectibility is not considered in the transaction price; however, it is a factor when determining whether a valid contract exists. There will be, in many instances, significant management judgments involved in this process with

[5] This guidance is based on FASB ASC 606-10-32-2 and 606-10-25-1.

potentially significant effects on revenue recognition. In accordance with paragraph .A2 of AU-C section 500 and paragraph .04 of AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), evidence beyond management's assertion or beyond an auditor's inquiry will ordinarily be sought[6] regarding management's assessments and judgments. The historical accuracy of collection estimates together with considerations of possible current and future changes will usually be considered by management and is a common auditor consideration when reviewing management's assessments and judgments.

2.11 On an ongoing basis throughout the term of the arrangement, auditors will need to consider entity procedures and controls over arrangements that did not initially meet the qualification criteria in FASB ASC 606-10-25-1 to determine whether the criteria are subsequently met. If a contract does not initially meet the criteria to be identified and accounted for as a contract under the standard, FASB ASC 606-10-25-6 requires a continuous assessment to determine if the criteria in FASB ASC 606-10-25-1 are subsequently met.

2.12 If an entity receives nonrefundable consideration from the customer, but the contract does not meet the criteria to be considered a contract under FASB ASC 606-10-25, an entity should recognize revenue only when certain specific events have occurred. As explained in FASB ASC 606-10-25-8, an entity should recognize the consideration received from a customer as a liability until one of the events in FASB ASC 606-10-25-7 occurs or until the criteria in FASB ASC 606-10-25-1 are met. Entities should not default to recognizing revenue on a cash basis in these situations, and auditors should be alert for potential errors or management bias and the potential to recognize revenue improperly in these circumstances.[7]

Combination of Contracts

2.13 *An entity should combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:*

- *The contracts are negotiated as a package with a single commercial objective,*
- *The amount of the consideration to be paid in one contract depends on the price or performance of the other contract,*
- *The goods and services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 14–22 of FASB ASC 606-10-25.*

2.14 Whether the contracts have been entered into at or near the same time is likely to require judgment by the entity. It may be difficult to assess

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[6] Paragraph .04 of AU-C section 580, *Written Representations* (AICPA, *Professional Standards*), states, in part, "Although written representations provide necessary audit evidence, they complement other auditing procedures and do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal."

[7] See paragraph .21 of AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AICPA, *Professional Standards*).

proper revenue recognition when one related contract is complete but, because the performance on another related contract is not complete, revenue may not be recognized. If the establishment of separate contracts and performance obligations can be performed or revised after the inception of the transactions, questions may arise about whether the contracts should be combined or whether a contract modification has resulted. If two or more contracts are inappropriately accounted for separately, the amount of consideration allocated to the performance obligations in each contract might not faithfully depict the value of the goods or services transferred to the customer. Auditors will usually need to evaluate the evidence management has established around management's criteria for combining (or not combining) contracts, and consider materiality and performance materiality thresholds when evaluating the contracts that were combined or not combined.

Contract Modifications

2.15 *An entity should account for a contract modification as a separate contract if both of the following conditions are present: (1) the scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 18–22 of FASB ASC 606-10-25), and (2) the price of the contract increases by an amount of consideration that reflects the entity's stand-alone selling prices of the additional promised goods or services.*[8] As explained in paragraph BC 76 of FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, the board's overall objective with the new contract modification guidance is to reflect an entity's rights and obligations arising from the modified contract. In order to "faithfully depict" an entity's rights and obligations arising from a modified contract, an entity may account for some modifications prospectively and others on a cumulative catch-up basis. As explained in FASB ASC 606-10-25-13, the accounting for a contract modification depends on whether the additional promised goods or services are distinct. The determination of how to account for a contract modification is likely to require judgment on the part of management, and auditors should apply the requirements in AU-C section 500 when seeking evidence of these judgments (refer to step 2 for additional details). Further, although it is always required that a contract be approved to apply modification accounting, if the entity has not yet determined the price, as required by FASB ASC 606-10-25-11, the entity should estimate the change to the transaction price arising from the contract modification using the variable consideration guidance. These circumstances will likely pose challenges for management, especially in situations without a final negotiated price.[9] Audit procedures over contract modifications will ordinarily include assessing the completeness of the population of contract modifications identified by management, and evaluating the sufficiency of evidence around approval of modifications to contracts without a final price. In addition, a potential issue could arise when overall contracts or individual performance obligations are not initially material, but then a change (in the contract or materiality) causes them to become material, either quantitatively, qualitatively, or both.

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[8] This guidance is from FASB ASC 606-10-25-12. Note that paragraphs 10–11 of FASB ASC 606-10-25 state that a modification is a change in the scope or price (or both).

[9] Note that the evaluation of contracts without a final negotiated price may be key, as that evaluation could determine whether such contracts are accounted for as a modification of an existing contract or a new contract.

Step 2: Identify the Performance Obligations in the Contract

2.16 Step 2 is a very important step for entities because significant judgment is involved in this area. Also, the identified performance obligations can vary from the units of accounting under pre-FASB ASC 606 revenue recognition guidance.[10] Audit procedures in the year of adoption should be performed to understand the nature of the contracts, the number of contracts, and controls over identifying performance obligations in contracts, among other things (see paragraph .12 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* [AICPA, *Professional Standards*]). This will ordinarily help define the nature of subsequent auditing procedures and the level of skill and knowledge necessary in order to test this area.

2.17 *A performance obligation*[11] *is a promise in a contract with a customer to transfer a distinct good or service or a series of distinct goods or services to the customer*. As explained in FASB ASC 606-10-25-16, the promised goods or services in a contract may be identified explicitly in that contract; however, in some cases, promises to provide goods or services may be implied by the entity's customary business practices. This factor highlights the importance of the auditor's understanding of the entity's business practices. The identification of performance obligations is an important issue for management to address because performance obligations are a foundation for appropriate revenue recognition. Early and ongoing analysis regarding new types of contracts can result in an awareness of new issues and a more effective approach to obtaining evidence and surfacing additional issues, if present. It will be important for the auditor to perform procedures (for example, examination of documents, inquiries, examining the basis for assertions) during the transition phase of adopting the new standard, and on an ongoing basis, to evaluate management's judgments and decisions regarding the changes required by FASB ASC 606.

2.18 *A good or service is distinct if both of the following criteria are met:*

- *Capable of being distinct—The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer, and*
- *Distinct within the context of the contract—The promise to transfer the good or service is separately identifiable from other promises in the contract.*

2.19 Entities and auditors should note that the concept of being "distinct" is from the customer's perspective. Contractual language may be unclear or misleading (for example, to a third party), so it is critical that management carefully analyze whether promised goods or services are distinct and consider the economic substance of the agreement. In accordance with paragraph .09 of AU-C section 500, the auditor should, to the extent necessary, examine the evidence that supports management's analysis or seek alternative or corroborating evidence, or both.

2.20 The determination about whether the goods or services are distinct will often require judgment. Although indicators are provided, there is no

[10] This is illustrated by efforts made by the FASB and IASB Transition Resource Group to clarify certain elements of the new guidance.

[11] The unit of account currently referred to as *deliverables* or *elements* in a multiple element arrangement is specifically defined in FASB ASC 606 and referred to as a *performance obligation*.

specified hierarchy of such indicators; it is possible that some indicators may point to the goods and services not being distinct and others may point to them being distinct. When extensive judgment is involved, issues of management bias and potentially insufficient audit evidence are likely to be present.

2.21 The second criterion for assessing whether a good or service is distinct is new, and management will usually establish a process around the evaluation of this criterion. This evaluation is to be performed on a contract-by-contract basis (or for certain portfolios of contracts that share similar characteristics)[12] because the same good or service may not be distinct in all instances. For example, a manufactured good may include components, but in some circumstances the performance obligation is for the delivery of the completed product rather than for the completion of individual components. On the other hand, in some telecommunication agreements, providing both equipment and access to transmission or receipt may be considered as separate performance obligations. In accordance with paragraphs .09–.10 of AU-C section 500, auditors should evaluate supporting evidence, as well as any contradictory evidence, regarding management's conclusions. Furthermore, the auditor may need to review contract cancellations to consider whether only certain elements are canceled versus the entire contract. Other audit procedures may include comparing the delivery (transfer of control) of various products or services to customers covered by a single contract to consider whether the delivery was dependent on other elements of the contract.

Promises in Contracts With Customers

2.22 *A contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.*[13] Implied promises from customary business practices may be a challenge for other than experienced employees to identify. Experienced auditors familiar with industry practices and entity business practices and controls may be needed to ensure audit team members are appropriately evaluating the entity's determination that such promises are indeed present. Communication with or evidence from the sales organization of the entity may be necessary for an auditor to assess and understand an entity's implied promises. Entities may be asked to articulate any such promises for relevant contracts and make specific representations that all such promises have been communicated to the auditors. Also, management will usually be expected to provide documentation of the entity's customary business practices when those practices create implied promises. Auditors may consider confirming the terms of the agreement directly with customers and may make inquiries to customers regarding unstated or implicit expectations or promises.

2.23 As listed in FASB ASC 606-10-25-18, promised goods or services may include, but are not limited to, the sale of goods produced by an entity; resale of goods purchased by an entity; performing a contractually agreed-upon task for a customer; or constructing, manufacturing, or developing an asset on behalf of a customer. Audit procedures may, in many cases, need to be designed to evaluate the entity's support for the reasonableness, completeness, and value of the identified promised goods or services.

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[12] See FASB ASC 606-10-10-4.

[13] This guidance is in accordance with FASB ASC 606-10-25-16.

Step 3: Determine the Transaction Price

2.24 *The transaction price is the amount of consideration (for example, payment) to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. An entity should include in the transaction price some or all of an estimate of variable consideration only to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.*[14] The new guidance creates a single model whereby variable consideration is included in the transaction price. The presence of variable consideration often creates challenges when determining proper revenue recognition. The auditor should assess management estimates of variable consideration in accordance with AU-C section 540 and determining the appropriate evidence in accordance with AU-C section 500, to support management's assertion as to the reasonableness and fairness of the estimate. Assessing whether it is probable that significant reversal in the amount of cumulative revenue recognized will not occur may require judgment and evaluation of different possible scenarios, depending on the type of transaction. Less resourced (for example, smaller) entities may need third-party assistance to help them develop the transaction price and the variable consideration component in more complex circumstances.

2.25 FASB ASC 606 created a new method for determining the transaction price by shifting from fees that are "fixed and determinable" to estimating variable consideration based on available information to identify a reasonable number of possible consideration amounts. As explained in FASB ASC 606-10-32-9, management should consider all the information (historical, current, and forecast) that is reasonably available to identify a reasonable number of possible consideration amounts. When considering the reasonableness and support for the method and information management used (historical, current, and forecast) to compute the variable consideration, frequently, auditors will ordinarily assess whether management has considered a reasonable number of possible consideration amounts. In addition, auditors should evaluate the relevant factors and assumptions that the entity has considered in making the estimate of variable consideration, including the entity's reasons for the particular assumptions (see paragraph .08 of AU-C section 540). In many cases, procedures will likely be performed to evaluate whether the assumptions made by the entity are based on reasonable assessments of present business circumstances and trends and the most currently available information; whether the assumptions are complete (that is, whether assumptions were made about all relevant factors); whether the assumptions are supported by reliable information; the range of the assumptions; and the alternatives that were considered but not used, including a reconciliation with information that may be contradictory to the final conclusion.[15] For example, auditors may need to understand how management considered the information available in the bid-and-proposal process when establishing prices for goods and services. Additional discussion of some of the existing requirements and guidance for auditors when auditing estimates

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[14] This guidance is in accordance with paragraphs 2 and 11–12 of FASB ASC 606-10-32.

[15] Note that management needs to make this assessment and not simply default to a minimum amount. The method selected when determining the transaction price is ordinarily expected to align with the facts and circumstances. For example, if there is a range of potential amounts, the probability weighted approach would likely be more appropriate, rather than the expected value approach.

related to revenue recognition can be found in the section of this chapter titled "Auditing Estimates."

2.26 FASB ASC 606-10-32-14 requires updating the estimate of variable consideration at the end of each reporting period. Normally, management is expected to establish a process to update this estimate. The auditor should apply the requirements of AU-C section 540 when testing this estimate, understanding that considerable judgment may be required. For example, when the credit profile of the buyer changes during the period of a long-term contract, the assumptions regarding the long-term contract need to be revisited by management and thus may need to be evaluated by the auditor. Consider example 20 from FASB ASC 606:

> *An entity enters into a contract with a customer to build an asset for $1 million. In addition, the terms of the contract include a penalty of $100,000 if the construction is not completed within 3 months of a date specified in the contract. The entity concludes that the consideration promised in the contract includes a fixed amount of $900,000 and a variable amount of $100,000 (arising from the penalty). The entity estimates the variable consideration in accordance with paragraphs 606-10-32-5 through 32-9 and considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.*[16]

2.27 FASB ASC 606-10-32-8 identifies two methods for estimating the variable consideration: the expected-value method and the most-likely-amount method. It notes the method that is the better predictor should be used. Throughout the life of the contract the same method should be used consistently. In accordance with paragraph .08 of AU-C section 540, auditors should (among other things) obtain an understanding of the valuation method (or model used) in the context of the applicable reporting framework, the method's application, relevant entity controls and the assumptions used in the valuation and in subsequent updates.

2.28 *An entity should adjust the promised amount of consideration for the effects of the time value of money if the timing of the payments agreed upon by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing for the transfer of goods or services to the customer. If a customer promises consideration in a form other than cash, the entity should measure the noncash consideration (or promise of noncash consideration) at fair value. If the consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity should account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity should account for such an excess as a reduction of the transaction price*. Some of the more complex audit issues may include, for example, the valuation of noncash considerations and how the risk of nonperformance was considered in the fair value measurement.[17] Timely identification of potential measurement issues can lead to more timely and compliant resolutions. It may also be important to address potential audit

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[16] See example 20, "Penalty Gives Rise to Variable Consideration," in "Pending Content" in paragraphs 194–196 of FASB ASC 606-10-55.

[17] See guidance in paragraphs 15, 21, and 25–26 of FASB ASC 606-10-32.

issues with contractual payment terms that exceed a year within the guidance in paragraphs 16–17 of FASB ASC 606-10-32.

2.29 *In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return*[18] *the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:*

- *A full or partial refund of any consideration paid,*
- *A credit that can be applied against amounts owed, or that will be owed, to the entity,*
- *Another product in exchange.*

2.30 Refunds have been identified in the past as transactions that were used to perpetrate fraud and thus could pose a risk with insufficient or ineffective controls around the process. Unusual patterns or amounts of refunds may reveal the need for further audit consideration and possibly more intense audit scrutiny and consideration of the period in which revenues were recognized. Determining the value of products or assets exchanged in lieu of refunds may also pose valuation issues. Refunds may also represent a change in the transaction price.

2.31 *An entity should account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 18–22 of FASB ASC 606-10-25) that the customer transfers to the entity.* Judgment will often be required when determining whether consideration payable to a customer is a reduction of transaction price or a separate expense. Auditors should apply the requirements in AU-C section 500 when testing this determination, assessing the evidence of the consideration payable and the conclusions reached by management regarding the consideration as a reduction of the transaction price or as a separate expense.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

Stand-alone Selling Price

2.32 *To allocate an appropriate amount of consideration to each performance obligation, an entity must determine the* [stand-alone] *selling price at contract inception of the distinct goods or services underlying each performance obligation and would typically allocate the transaction price on a relative* [stand-alone] *selling price basis.* Management will typically establish a process for applying the relative stand-alone selling price approach when allocating the transaction price or the use of the exceptions (for allocating discounts and variable consideration) because this is a matter of judgment. As explained in FASB ASC 606-10-32-32, the best evidence of a stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. If the stand-alone selling price is not directly observable, the entity should estimate it. FASB ASC 606-10-32-33 states that an entity should allocate a portion of

[18] As stated in FASB ASC 606-10-32-6, refunds can be considered as variable consideration when determining transaction price.

the transaction price to each obligation based on an estimate of its stand-alone selling price even if its value is not readily observable. The process around estimating stand-alone selling prices to the extent the prices are not observable is likely to be new for some entities. Management is required to maximize the use of observable inputs, and auditors should evaluate those estimates based on market conditions and entity-specific factors (see paragraphs .08 and .13 of AU-C section 540).

2.33 Documentation of management policies, procedures, and outcomes may need to be robust, especially in more complex environments. In circumstances in which an entity must estimate stand-alone selling prices, FASB ASC 606-10-32-34 provides three acceptable estimation approaches: the adjusted market assessment, expected cost plus a margin, and the residual approach. The objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer. Defaulting to the residual method may violate this concept and may fail to represent the economics of the transaction. The residual method is to be used only if specific criteria are met. In accordance with paragraph .13 of AU-C section 540, auditors should, among other procedures, evaluate and test the appropriateness of the methods selected and the evidence regarding those methods.[19]

2.34 Sometimes the transaction price includes a discount or variable consideration that relates entirely to one of the performance obligations in a contract. The requirements specify when an entity should allocate the discount or variable consideration to one (or some) performance obligation(s) rather than to all performance obligations in the contract.

2.35 *An entity should allocate a discount entirely to one or more, but not all, performance obligations in the contract if all the following criteria are met:*

a. *The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a* [stand-alone] *basis*

b. *The entity also regularly sells on a* [stand-alone] *basis a bundle (or bundles) of some of those distinct goods or services at a discount to the* [stand-alone] *selling prices of the goods or services in each bundle, and*

c. *The discount attributable to each bundle of goods or services described in 2.32*b. *is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.*[20]

2.36 The ability to allocate a discount to some but not all performance obligations is a significant change from current practice. However, the criteria in FASB ASC 606-10-32-37 indicating when a discount should be allocated to some but not all performance obligations will likely limit the number of transactions

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[19] Note that FASB ASC 606 does not establish a hierarchy of evidence, as does the current (pre FASB ASC 606) software revenue recognition guidance.

[20] This guidance is in accordance with paragraphs 36–37 of FASB ASC 606-10-32.

to which the discount can be allocated. The "observable" evidence criteria in FASB ASC 606-10-32-37 requires documentation and established processes by the entity, which may often have control implications. If the observable evidence criteria in FASB ASC 606-10-32-37 are met, the discount should be attributed to one or more performance obligations. Auditors should apply the guidance in AU-C section 540 and AU-C section 500 when considering the reasonableness of management's assessments and judgments and obtaining evidence regarding the reasonableness of the assessment.

2.37 *An entity should allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation in accordance with FASB ASC 606-10-25-14(b) if both of the following criteria are met:*

- *The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service), and*
- *Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective in FASB ASC 606-10-32-28 when considering all of the performance obligations and payment terms in the contract.*[21]

2.38 The burden of evaluating and allocating variable consideration and monitoring resulting changes in transaction price, while also taking into consideration financing and noncash considerations, may be greater on smaller entities with more limited accounting resources but may be a challenge for entities of any size. Evidence will often be sought by auditors in accordance with AU-C section 500 to evaluate management judgments necessary to conclude that the terms of the variable payment "relate specifically" to the entity's efforts to satisfy a performance obligation and that the allocation of the variable payment to a performance obligation results in a transaction price allocation consistent with the objective stated in FASB ASC 606-10-32-28. As explained in FASB ASC 606-10-32-14, the variable consideration estimates should be updated and auditors in many cases will need to test the updated estimates and obtain evidence of the reasonableness of the conclusions reached.

Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

2.39 An entity should *recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (that is, an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.*[22] Paragraphs 27–30 of FASB ASC 606-10-25 list criteria for determining whether a contract is satisfied over time and—if the contract is not satisfied over time—indicators of the point in time at which control transfers to the customer. This is an area that can result in changes in revenue recognition compared to current guidance. It will often be important for management to be clear about when obligations are satisfied. Management in many cases will design controls over the process it will use to determine the point in time at

[21] This guidance is in accordance with FASB ASC 606-10-32-40.
[22] This guidance is based on FASB ASC 606-10-25-23.

which control has transferred or to measure progress toward completion of a performance obligation satisfied over time.

2.40 *For each performance obligation satisfied over time in accordance with paragraphs 27–29 of FASB ASC 606-10-25, an entity should recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation. An entity should apply a single method of measuring progress for each performance obligation satisfied over time, and the entity should apply that method consistently to similar performance obligations and in similar circumstances.*[23] Assessing the satisfaction of performance obligations over time often requires judgment and the consideration of many criteria and sub-criteria that should be met to qualify. The enforceability criteria for right to payment for performance completed to date and other assumptions may be subject to legal determination. Thus, processes may need to be established to connect accounting and legal, including possible controls over contract accounting. Also, because entities are required to remeasure progress toward complete satisfaction of a performance obligation satisfied over time at the end of each reporting period, judgment may often be needed to evaluate that these are changes in estimate and not errors. Further, management judgment is required when selecting a method of measuring progress toward complete satisfaction of a performance obligation. This does not mean entities have a "free choice." Management will likely need to establish parameters for selecting an input method or an output method and possibly design controls for reviewing the ongoing application of these methods. As stated in FASB ASC 606-10-25-31, management's selection of this method should consider that "the objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation)." The more management judgment is involved, the more robust management's documentation may be expected to be. Going forward, these criteria may result in changes in the way contracts are written.[24]

2.41 For performance obligations satisfied at a point in time, the indicators of the transfer of control to be considered include but are not limited to whether the customer presently is obligated to pay for an asset, whether the customer has legal title to the asset, whether the entity has transferred physical possession of the asset, whether the customer has assumed the significant risks and rewards of ownership of the asset, and whether the customer has accepted the asset.[25] The determination about when control is transferred in some cases will require considerable judgment and analysis of the contract, legal interpretations, and representations supporting the evidence examined. In many cases it will be possible for the entity to establish effective activity-level controls[26] (for example, establishing and following shipping terms) around these and other revenue recognition criteria to ensure revenue is recognized in accordance with FASB ASC 606. Confirmations may be used to evaluate whether performance obligations and customer acceptance warrant revenue recognition.

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[23] This guidance is based on paragraphs 31 and 32 of FASB ASC 606-10-25.

[24] Special attention may be warranted for contracts that are currently in place but incomplete at the time of the transition to FASB ASC 606. Refer to the section of this chapter titled "Auditing Considerations in the Adoption and Transition to FASB ASC 606."

[25] This guidance is based on FASB ASC 606-10-25-30.

[26] Activity-level controls (control activities) are a component in COSO's internal control framework. They include controls related to financial transactions.

Auditing Considerations in the Adoption and Transition to FASB ASC 606

2.42 FASB ASC 606-10-65-1 explains that when adopting FASB ASC 606, there are two options: the full retrospective approach and the modified retrospective approach. Under the full retrospective approach, prior periods would be recast in accordance with FASB ASC 250, *Accounting Changes and Error Corrections*. The disclosures required by paragraphs 1–3 of FASB ASC 250-10-50 under this approach include any practical expedients used and, to the extent possible, a qualitative assessment of the estimated effect of applying each of the practical expedients. The auditor should obtain evidence supporting these disclosures, unless deemed not material, and accordingly may be anticipated by the entity to ensure the auditability of the process and conclusions. In many cases, auditors will seek evidence that the practical expedient is consistently applied in all presented periods, because consistent application to all contracts within all reporting periods presented is a requirement for any practical expedients used. Also, for variable consideration, auditors ordinarily will need to obtain contemporaneous documentation that clarifies what information was available to management, and when it was available, for contracts that are in progress but not completed at the adoption date or for completed contracts where the practical expedient for variable consideration was not employed. Auditors will often look to management to provide sufficient evidence supporting the proposed accounting treatment.

2.43 Under the modified retrospective approach, in accordance with FASB ASC 606-10-65-1(h), entities may elect to apply FASB ASC 606 to all contracts at the date of initial application or only to contracts that are not completed at the date of initial application (see FASB ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*), as of the effective date and record a cumulative catch-up adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) of the annual reporting period that includes the date of initial application. Required disclosures (in accordance with FASB ASC 606-10-65-1[i]) include the amount by which each financial statement line item is affected in the current reporting period by the application of FASB ASC 606 and an explanation of the reasons for significant changes in the financial statement line items. Evidence supporting these disclosures will likely be sought by the auditor (see paragraph .06 of AU-C section 500) and considered in advance of the audit by the entity to ensure the auditability of the process and conclusions.

2.44 Upon adoption, FASB ASC 606 will require some entities to accelerate revenue recognition, whereas others will defer revenue recognition because of the differences in the requirements. An entity may need to adjust revenues as a result of differences in the standards for contracts that span multiple reporting periods. As a result, because of the restatement of revenues in some prior periods, prior scoping decisions regarding the precision with which some revenue streams were audited in the past may need a re-assessment of the audit procedures and testing approach with respect to the restated periods and the current period. Similarly, for multilocation entities, the adequacy of the scope of procedures previously determined to apply to certain locations may need to be reconsidered for certain locations and in certain accounts that become more or less prominent due to the change in the revenue recognition standard. A location not initially in scope may become in scope in future periods.

2.45 In many cases, consistent with AU-C section 315, auditors should consider if there are risks of misstatements associated with the transition and in many cases will seek to identify controls over recording any change in accounting principle. The auditor should consider these risks and disclosures in the context of a change in accounting principle as noted in paragraph .07 of AU-C section 708, *Consistency of Financial Statements* (AICPA, *Professional Standards*). In the transition to FASB ASC 606, the previous policies and new requirements may be compared and contrasted to identify potential transition issues and required tasks to revise past financial statement amounts in accordance with the transition approach selected by the entity. For example, as it relates to FASB ASC 606, risks considered in this assessment may include these risks:

- The entity may not identify all revenue contracts relevant to each reporting period to be presented under FASB ASC 606.
- The entity may inappropriately determine that a contract is completed when not all (or substantially all) of the revenue was recognized under legacy GAAP.
- The entity does not properly disclose the adoption of FASB ASC 606 and the practical expedients.
- Management may not be fully versed in FASB ASC 606 or prepared with adequate resources to account for, and disclose, the transition properly.

2.46 Audit considerations would also include the internal control framework components, as follows:

- *Control environment*. The tone at the top regarding FASB ASC 606 can be important. Has the entity set up appropriate training for all affected business functions, including, but not limited to, legal, tax, and sales?
- *Risk assessment*. Has management performed an effective risk assessment over the financial reporting risks in the adoption of FASB ASC 606 as well as the risks over the transition? Has fraud risk been considered in conjunction with the changes?
- *Control activities*. Have controls been designed to properly identify when and how much revenue is to be recognized? Have controls been established over any amounts or disclosures required by FASB ASC 606 in the period of adoption?
- *Information and communication*. Has management evaluated how to modify internal and external reporting systems to reflect the transition to FASB ASC 606? Is the data required for transition readily available and in useable form? When some form of dual reporting will be followed, have processes and systems been adapted to meet the information needs? Has management effectively communicated its transition method and any implications to users of the financial statements (for example, investors)?
- *Monitoring*. What is management doing to monitor issues arising from the transition process and implementation of FASB ASC 606?

2.47 If relevant to the audit, the auditor, should evaluate the controls designed by the entity to address risks listed in paragraph 2.45.[27] When placing reliance on controls over the transition process, auditors should test such controls as required under paragraph .08 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*). Specific controls-related issues the auditor might consider in understanding and planning to test controls may include the following:

- How have accounting systems changed in transitioning to FASB ASC 606? Have appropriate systems change processes worked well in the transition? Have programs written to assist in making the conversion and disclosures been tested and verified?
- Has management determined how any new controls will be monitored? Have oversight and monitoring procedures been fully adapted to FASB ASC 606?

2.48 Consistent with paragraphs .13–.14 of AU-C section 315, the auditor should obtain an understanding of the entity's controls designed to address the risks of material misstatement related to adopting FASB ASC 606. When assessing whether there is sufficient precision to prevent or detect potential misstatements, auditors will ordinarily consider the following:

- Because FASB ASC 606 requires a significant amount of judgment, many of the controls will likely include management reviews performed by the entity. Has the entity provided sufficient training to personnel to perform review controls that will address the risks of material misstatement? Are reviews performed by personnel with the requisite technical expertise and knowledge of the entity's business operations? What does the entity do to keep management informed on evolving issues relevant to the entity? Are reviews performed in a timely manner to allow sufficient time for correction and remediation if necessary?

2.49 What controls has the entity implemented to account for revenue during the period of transition (for example, accounting for revenue under pre- and post-FASB ASC 606 guidance)? What are the entity's controls to move over from one IT system to another?

2.50 Advance consideration is advisable regarding the timing of audit procedures. Ideally, management would design and implement its transition plan before auditor assessment and testing begins. Entities should be mindful of the timing of audit procedures, knowing that these procedures will likely be performed on reported amounts and disclosures in order to be able to have financial statements released on a timely basis.

2.51 Although some evidence may only be observable in the period of the transaction, in other situations hindsight may be helpful in obtaining evidence for amounts that originally were estimates. Differences in revenue recognition arise, in many cases, because FASB ASC 606 involves the use of estimates. To illustrate, the third step for recognizing revenue under FASB ASC 606 is

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[27] See paragraph .14 in AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*).

to determine the transaction price, which can be particularly subject to judgment. When auditing the retrospective period(s), the auditor may need to use evidence obtained after the transaction occurred because details of the transaction that would have been originally estimated are now available. When auditing the retrospective period(s), the auditor may need to use historical data as evidence when evaluating these estimates. However, when using hindsight to evaluate estimates, the auditor may often consider information that was reasonably knowable by management at the contract date.[28] Note that FASB ASC 606-10-65-1(f)(2) allows for a practical expedient whereby "For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods." Therefore, if this practical expedient is elected, there is no reason for either the entity or the auditor to have to use hindsight.

2.52 If the consideration promised in a contract includes a variable amount, the entity may estimate the amount of consideration to be received in exchange for transferring the goods or services when determining the transaction price. If the contract is completed within the reporting period, rather than estimating the variable consideration, the entity may use the transaction price at the date the contract was actually completed. The use of hindsight evidence is subject to less judgment and can be tested more efficiently by the auditor than an estimate, especially if the auditor notifies management that they will likely need to provide the data to the auditor for testing. However, for contracts that span reporting periods, auditors may need to test management's methods and assumptions or develop their own model resulting in a range or estimate of the amounts.

2.53 Early in the risk assessment and planning process, the auditor should understand, evaluate, and gather evidence (positive and negative) regarding the significant assumptions and the judgments made by management specific to the retrospective period(s), in accordance with AU-C section 540. This is to anticipate and plan for foreseeable issues that could arise during the engagement. The considerations involved and assumptions used to form the judgments for the retrospective period(s) will likely align with assumptions relating to other estimates. The auditor may benefit from discussing these assumptions with experienced members of the audit team to determine whether the entity has made consistent judgments and assumptions. In many cases, contradictory evidence and evidence from procedures performed related to other accounts, such as receivables, cash, inventory, or allowances,[29] that might not be consistent with evidence used in developing the assumptions should be evaluated and reconciled with other evidence or conclusions reached by the auditor (see paragraph .10 of AU-C section 500).

2.54 *Impact on the auditor's report.* In accordance with paragraphs .07–.12 of AU-C section 708, if a change in accounting principle (for example, from the adoption of FASB ASC 606) has a material effect on the financial statements, the auditor should include an emphasis-of-matter paragraph in the auditor's report that describes the change in accounting principle and provides a reference to the entity's note disclosure.

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[28] Hindsight may be an appropriate approach to apply for in-process contracts.

[29] New accounts related to contract assets or liabilities should also be considered.

General Audit Considerations Over Revenue Recognition[30]

2.55 Auditing revenue recognition will continue to be considered a presumed fraud and significant audit risk (rebuttable) under the new standard (see paragraph .26 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* [AICPA, *Professional Standards*]). The auditor's understanding of the entity's business—how it earns revenue, who is involved in the revenue process, how its controls over revenue transactions may be overridden, and what its motivation to misstate revenue may be—is important in helping the auditor reduce that risk. Auditors should pay particular attention to "red flags" and warning signals such as fraud risk factors (see paragraphs .22–.24 and appendix A, "Examples of Fraud Risk Factors," of AU-C section 240). The auditor should plan and perform the audit with an attitude of professional skepticism (see paragraph .08 of AU-C section 240). Additional audit procedures directed to the audit of revenue (due to the additional requirements of the new standard and disclosures) may be needed to reduce the risk of failing to detect material misstatement of the financial statements to an acceptably low level. See the following table for a list of financial statement assertions linked to key audit considerations over revenue.

Assertions[31]	***Assertion Considerations***
Occurrence or Existence	An entity may be pressured or incentivized to overstate their revenue in order to achieve specific financial results. This risk may result in the overstatement of revenue recorded in the current period under audit and require a specific audit plan focusing on this risk.
Rights and Obligations	An entity may fail to appropriately identify all the performance obligations within a contract (either through error or fraud). This may result in the improper acceleration or deferral of recorded revenue.
Completeness	An entity may intentionally understate their recorded revenue for various reasons, including situations where the entity had a year of poor financial performance with the anticipation of a better performance in the following year, to avoid taxation or provide an illusion of a "recovery" in the next period.

[30] This section is intended to provide broad, general guidance and is not a substitute for specific guidance regarding the accounting and auditing guidance under the new revenue recognition standard.

[31] Alternative schema for audit assertions are acceptable provided they address the same risks as those illustrated in the generally accepted auditing standards.

Assertions	*Assertion Considerations*
Accuracy or Valuation and Allocation	Transactions subject to a high degree of estimation and management judgment may create risks related to inaccurate amounts being recorded as revenue. The determination of the stand-alone selling price may create a risk of material misstatement based on the nature of the entity's goods or services. In addition, including variable consideration in the transaction price, while failing to consider the constraint guidelines in paragraphs 11–13 of FASB ASC 606-10-32, could result in an overstatement of the amount of revenues recognized in different reporting periods.
Cutoff	Revenue may not be recorded in the correct accounting period, such as when revenue is based on satisfying performance obligations in a future period but is recorded in the current period.
Presentation and Disclosure	Revenue and related financial statement accounts may not be presented in accordance with the requirements of the standard and entity policy, especially due to the new requirements to present revenue from contracts with customers separately, as well as the related contract asset and contract liability presentation requirements. For example, consider principal versus agent and gross versus net issues.

2.56 The general audit process associated with any engagement or audit area is addressed in AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit*. Inherent risk assessment, control risk assessment, and analytical and substantive detail procedures are evaluated to ensure audit risk related to revenue is reduced to a low level by addressing the financial statement assertions in the preceding table.[32]

2.57 In many cases, the inherent risk for the existence assertion of a portion or subset of revenues may be assessed as high due to presumed fraud risks or other significant risks that often surround revenue recognition. The 2014 Association of Certified Fraud Examiners study, *Report to the Nations on Occupational Fraud and Abuse*, found that 61 percent of financial statement fraud cases involved revenue recognition. Thus, additional attention to revenue recognition and related disclosures is often warranted in audit engagements.

2.58 When the auditor's strategy is to rely on controls regarding revenue assertions, relevant controls to mitigate specific identified risks from risk assessment should be in place and tested for operating effectiveness. The effective design of controls over revenue risks is derived from the risk assessment that management develops and the auditor reviews and assesses. Regardless of whether the auditor plans to test and rely on controls, important high inherent risks in significant accounts or audit areas and for key assertions that are not addressed by controls are likely to indicate a significant deficiency or material weakness in the design of the controls. If controls are designed effectively

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[32] Alternative schema for audit assertions are acceptable provided they address the same risks as those illustrated in the generally accepted auditing standards.

and evidence exists of their implementation (for example, through examining evidence, observation or walkthroughs of controls) to reduce audit risk, the controls should be tested as described in paragraphs .08–.09 of AU-C section 330, if the auditor plans to rely on them. The nature and extent of procedures applied is dependent on the level of reliance sought by the auditor.

2.59 When non-sampling procedures are appropriate (for example, assessing the effectiveness of the governance structure), gathering more evidence or more appropriate evidence to test the operating effectiveness of the control can support higher reliance on controls. When sampling is employed, chapter 3, "Nonstatistical and Statistical Audit Sampling in Tests of Controls," of AICPA Audit Guide *Audit Sampling* indicates that high reliance is often associated with sampling risk of no more than 10 percent (that is, 90 percent confidence) and tolerable deviation rates of 10 percent or less. Because of the sensitive nature of revenues, some auditors may use more stringent risk and tolerable deviation rate criteria in their control test designs when the highest level of reliance is placed by auditors on the entity's controls.

2.60 Paragraphs .26–.27 of AU-C section 240 state, in part

- "When identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks."
- "The auditor should treat those assessed risks of material misstatement due to fraud as significant risks and, accordingly, to the extent not already done so, the auditor should obtain an understanding of the entity's related controls, including control activities, relevant to such risks, including the evaluation of whether such controls have been suitably designed and implemented to mitigate such fraud risks."

2.61 When engagement circumstances indicate that revenue contains neither a fraud risk nor a significant risk, the auditor should document the reasons for this in the working papers[33] and proceed to audit revenue as with any other account. When revenue, before the consideration of controls, is a significant risk and reliance on revenue controls is planned, the auditor should perform control tests on an annual basis[34] and perform some other substantive procedure (for example, effective analytical procedures or substantive detail tests) to reduce audit risk.

2.62 As described in paragraph .22 of AU-C section 240, analytical procedures should also be applied to revenue to detect possible risks of error or fraud. Such procedures may include comparisons to production capacity, a comparison of sales to shipments, or a monthly trend line of sales and returns to detect fictitious sales or side agreements that may preclude revenue recognition, as described in paragraph .A26 of AU-C section 240. Paragraphs .A57–.A58 of AU-C

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[33] See paragraph .46 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*).

[34] AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), generally allows controls test results to be carried over for two additional audit periods when no changes have occurred in the control procedure (see paragraphs .13–.15 of AU-C section 330). Controls related to significant risks should be tested annually.

section 240 further note that uncharacteristic sales patterns at year end can indicate misstated revenues caused by fraud (or error). Additional audit procedures that might be applicable to revenue are noted in appendix B, "Examples of Possible Audit Procedures to Address the Assessed Risks of Material Misstatement Due to Fraud," of AU-C section 240. The level of data aggregation used in the analysis (for example, consolidated or disaggregated, by location, or by product line) and the resulting precision of the procedures can influence the level of assurance obtained by these procedures. The degree of precision of the procedures and the value of the evidence obtained is also responsive to the amount of change in the account that is explained by the procedure performed and the follow-up evidence examined.

2.63 Substantive tests of details by assertion may also be planned to reduce the audit risk in revenues to a low level. The extent of sampling procedures to be performed is responsive to the audit strategy and the results of other revenue-related procedures. When the extent of evidence gathered to support an account balance does not seem to reduce risk to a low level, the extent of substantive test evidence may not provide sufficient evidence.

2.64 When planning substantive procedures, consideration of the assertions can assist in the appropriate extent of procedures to be performed. The revenue account is related to other accounts such as cash, accounts receivable contract assets, contract liabilities, and sometimes inventory. If existence of revenues is mostly satisfied through procedures performed in accounts receivable and cash (for example, if not collected, then accounts receivable may include improperly recognized revenue) and analytical procedures, then less direct testing of revenues for the existence assertion may be warranted. Similarly, an entity with a simple revenue recognition model may be exposed to less risk resulting in less testing of the valuation assertion than an entity with a complex array of revenue recognition issues. As described in chapter 4, "Nonstatistical and Statistical Audit Sampling for Substantive Tests of Details," of AICPA Audit Guide *Audit Sampling*, assertion-based testing may be an efficient approach when designing tests directed primarily to the valuation assertion. Careful documentation of this strategy and a basis for any underlying assumptions when it is employed can create a clear record of the procedures performed and the basis for the extent of testing performed.

2.65 When controls over the revenue recognition process are adequately designed and implemented, auditors may find it more efficient to test and rely on those controls and reduce the extent of substantive detail tests of revenues. Because tolerable misstatement and performance materiality in a substantive test of detail are, in many cases, a small percentage of the aggregate value of revenues, sample sizes to substantively test revenues can be very large. By following a strategy of testing controls to demonstrate they are effective and performing substantive analytics, the required assurance from substantive detail tests may be reduced and still lead to a low overall audit risk of revenues. Higher acceptable sampling risk (the complement of the level of assurance or confidence level) leads to smaller substantive detail test sample sizes.

2.66 When tests of controls effectiveness are not performed and when relevant assertions related to revenue recognition are considered significant risks, the auditor relies solely upon substantive tests to conclude on the reasonableness of revenues. Under these circumstances, the auditor cannot rely solely on substantive analytical procedures, and the audit tests should include tests of details (see paragraph .22 of AU-C section 330).

Risk Assessment and Fraud Risk Under FASB ASC 606

2.67 Prior to performing audit procedures, issues related to the transition to FASB ASC 606 are likely to be included in the planning process. Even in advance of the implementation date of FASB ASC 606, auditors are urged to meet with management and those charged with governance to discuss management's approach and readiness to make the transition. Advance planning will often make for a smoother transition for entities and auditors. Current surveys indicate that, as of mid-2016, many public and private entities have yet to begin assessing what may be necessary to make the transition. Additional guidance regarding risk assessment during the transition phase can be found in the section of this chapter titled "Auditing Considerations in the Adoption and Transition to FASB ASC 606."

Audit Planning

2.68 AU-C section 300, *Planning an Audit* (AICPA, *Professional Standards*), establishes requirements and provides guidance on the considerations and activities applicable to planning an audit conducted in accordance with GAAS. These activities and considerations include establishing an understanding with the client, preliminary engagement activities, establishing the overall audit strategy, developing the audit plan, determining the extent of involvement of professionals with specialized skills, and communicating with those charged with governance. The nature, timing, and extent of planning vary with the size and complexity of the entity and with the auditor's experience with the entity and understanding of the entity and its environment, including its system of internal control. When the engagement involves group audit issues, additional planning considerations and communications may be involved.

2.69 Paragraph .A2 of AU-C section 300 states that planning is not a discrete phase of the audit, but rather a continual and iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion. The following paragraphs describe some planning considerations related to FASB ASC 606.

Assignment of Personnel and Supervision

2.70 AU-C section 300 also discusses the supervision of personnel who are involved in the audit. The extent of appropriate supervision in a given instance depends on many factors, such as the complexity of the subject matter and the qualifications of persons performing the work, including their knowledge of the entity's business and industry. An understanding of an entity's business, its accounting policies and procedures, and the nature of its transactions with customers is useful in assessing the extent of experience or the level of supervision appropriate to audit revenue transactions.

2.71 Unusual or complex transactions, related-party transactions, and revenue transactions based on contracts with complex terms ordinarily signal the need for more experienced personnel assigned to those segments of the engagement, more extensive supervision, or the use of industry or other specialists. If specialized skills are needed, the auditor may often seek the assistance of a professional possessing such skills who may be either on the auditor's staff or an outside professional. AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), establishes requirements and provides guidance to auditors who use the work of a specialist[35] in performing an audit in accordance with GAAS. When evaluating an entity's transition plans and resources to perform the transition to FASB ASC 606, the auditor may seek assistance from someone with a highly detailed understanding of FASB ASC 606. The auditor should also be sensitive to when legal or other specialist assistance may be needed by the entity or auditor to successfully perform the assessment.

Establishing an Overall Strategy

2.72 AU-C section 300 requires establishment of an overall strategy. Two elements of the overall strategy include identification of the engagement's characteristics and consideration of factors that are significant in directing the engagement team's efforts. The entity's process and methods for recognizing revenue would normally be a key characteristic of the engagement, as would be the types of contracts the entity enters into with its customers. FASB ASC 606 requires substantial judgment by the entity and, therefore, may often result in the auditor exercising professional judgment and skepticism when designing the audit plan. Both of these considerations are often addressed in the overall strategy of the audit.

Audit Risk

2.73 Paragraph .A1 of AU-C section 320, *Materiality in Planning and Performing an Audit* (AICPA, *Professional Standards*), states that "audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk." The auditor considers audit risk in relation to the relevant assertions regarding individual account balances, classes of transactions, and disclosures and at the overall financial statement level.

2.74 At the account balance, class of transaction, relevant assertion, or disclosure level, audit risk consists of (*a*) the risks of material misstatement (consisting of inherent risk and control risk) and (*b*) detection risk. Paragraph .26 of AU-C section 315 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and the relevant assertion level as a basis for designing and performing further audit procedures (tests of controls or substantive procedures). It is not acceptable to simply deem risk to be "at the maximum." This assessment may be expressed in qualitative terms, such as high, medium, or low, or in quantitative terms such as percentages (for example, of risk). Furthermore, the basis for the assessment provides the evidence supporting the risk assessment and communicates important information for other audit personnel and reviewers of the assessment.

2.75 Revenue often contains considerable risks of misstatement and, as a result, receives considerable audit attention. Relevant assertions the auditor may consider include occurrence or existence, completeness, valuation or accuracy, cutoff, and presentation and disclosure.[36] Note that the new guidance on

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[35] Paragraph .06 of AU-C section 620, *Using the Work of an Auditor's Specialist* (AICPA, *Professional Standards*), defines, in part, an auditor's specialist as "An individual or organization possessing expertise in a field other than accounting or auditing..." The nature of the assistance provided to the entity or auditor in many cases can be important in determining whether a specialist is involved.

[36] Note that other assertions may be adopted by auditors provided that they address a complete set of risks.

revenue recognition requires substantial new disclosures, and may increase the risks related to presentation and disclosure. The revenue cycle is also commonly identified as a significant class of transactions and a presumed significant risk and fraud risk (rebuttable presumption). Accordingly, a comprehensive understanding of this cycle, including the entity's continuing business practices, is often necessary to properly assess risk.

2.76 In considering audit risk at the overall financial statement level, it is important for the auditor to consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and that potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of controls. The competence and ability of the entity's resources to conduct the revenue recognition transition process and develop the required disclosures can signal an important risk and affect which audit resources are most suited to the engagement.

Understanding the Entity and Risk Assessment

2.77 Paragraph .03 of AU-C section 315 states that "the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's system of internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement." As noted in AU-C section 240, revenue recognition is presumed to be a fraud risk. However, this presumption can be overcome by facts and circumstances of the entity. When this presumption is overcome, the auditor should document the reasons for this conclusion (see paragraph .46 of AU-C section 240).

2.78 Obtaining an understanding of the entity and its environment, including its system of internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit.

2.79 In accordance with paragraph .A3 of AU-C section 315, the auditor uses professional judgment to determine the extent of understanding required about the entity and its environment, including its system of internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess the risks of material misstatement of the financial statements and to design and perform further audit procedures (tests of controls and substantive tests). Further discussion of the role of controls in the recognition of revenue can be found in the section of this chapter titled "Risk Assessment and Fraud Risk Under FASB ASC 606."

2.80 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance

- Selection and application of accounting policies (see the following section for further discussion)
- Whether principal and agent issues or licensing issues may exist in business transactions and how management has analyzed their effects, if any, on revenue recognition

2.81 Refer to appendix A, "Understanding the Entity and Its Environment," and appendix B, "Internal Control Components," of AU-C section 315 for examples of matters that the auditor may consider when obtaining an understanding of the entity and its environment relating to the categories in the preceding list.

2.82 With regard to assertions about revenue, the auditor may consider obtaining information relating to the following matters:

- The nature and extent of an entity's performance obligations, including types of products and services sold
- The effects of licensing agreements or the existence and effect of principal/agent issues
- The types of contracts, including oral or implied contracts, and whether changes can be made to standardized contracts
- Whether seasonal or cyclical variations in revenue may be expected
- The sales policies customary for the entity and the industry
- Policies regarding pricing, price concessions, sales returns, discounts, extension of credit, contingencies, and normal delivery and payment terms
- Who, particularly in the marketing and sales functions, is involved with processes affecting revenues, including order entry, extension of credit, price concessions and shipping
- Whether there are compensation arrangements that depend on the entity's recording of revenue. For example, whether the sales force is paid commissions based on sales invoiced or sales collected, and the frequency with which sales commissions are paid, might have an effect on the recording of sales at the end of a period as well as on how the entity measures, analyzes, and reviews its financial performance to identify the internal and external pressures on the entity
- The classes and categories of the entity's customers, including whether there are sales to distributors or value-added resellers or to related parties
  - If sales to distributors are material, it is important to understand whether concessions have been made in the form of product return rights or other arrangements in the distribution agreements the entity has entered into.
  - Distribution agreements in the high-technology industry might include such terms as price protection, rights of return for specified periods, rights of return for obsolete products, and cancelation clauses such that the real substance of the agreement is that it results in consignment inventory.

- The nature and frequency of contract or revenue policy modifications.

2.83 In the transition to FASB ASC 606, the previous policies and new requirements may be compared and contrasted to identify potential transition issues and required tasks to revise past financial statement amounts in accordance with the transition approach selected by the entity.

2.84 Auditors may find procedures such as those subsequently described to be useful in obtaining knowledge about an entity's sales transactions.

Inquiry

2.85 Inquiry of management is an effective auditing procedure in obtaining knowledge of the entity and its system of internal control. In situations involving unusual or complex revenue transactions, the auditor may consider making inquiries of representatives of the entity's sales, marketing, customer service and returns departments, and other entity personnel familiar with the transactions to gain an understanding of the nature of the transactions and any special terms that may be associated with them. Such inquiries may also be useful in assisting with the auditor's understanding of the entity's customary business practices and whether any verbal or implied contracts may exist. Inquiries of legal staff may also be appropriate when sales contracts have nonstandard, unusual, or complex terms. Inquiry alone is ordinarily not a sufficient auditing procedure, but information obtained from discussions with management and entity personnel may help the auditor identify matters to be corroborated with evidence obtained from other procedures, including confirmation from independent sources outside the entity.

2.86 Interviews may also help the auditor identify potential performance obligations associated with transactions. When a potential performance obligation is identified, further inquiries may assist in forming the auditor's risk assessment and the design of further audit procedures.

Reading and Understanding Contracts

2.87 The auditor should read and understand the terms of sales contracts when necessary to obtain an understanding of what the customer expects and what the entity is committed to provide (see paragraph .12 *b*(i) and (iv)of AU-C section 315). In addition, reading the contents of the entity's sales contract (and sales correspondence) files may provide evidence of side agreements or performance obligations (for instance, by identifying options within a contract that provide a customer with a material right to be further evaluated by management to determine whether that right is a performance obligation). In addition to written provisions, implicit provisions and unstated business conventions that may be present in contractual arrangements may need to be considered. In some cases, the presence or absence of such provisions may be verified through customer confirmation or through a thorough review of deal proposals or marketing materials. Third-party evidence is generally considered to be more appropriate when obtainable.

Reviewing Process Narratives and Process Flow Diagrams

2.88 When available, requesting and reviewing the entity's process narratives and process flow diagrams for the revenue process(es) may help the auditor obtain an understanding of the detailed steps of the process and controls, which may assist in risk assessment. In the transition process, unique or different approaches and controls may be designed to determine the amounts and disclosures required under FASB ASC 606. The processes and controls established for the transition phase may be important in ensuring that adequate support exists for the amounts and disclosures required at the inception of the transition.

Reviewing Internal Control Manuals, Policy Manuals, or Similar Documentation

2.89 When available, requesting and reviewing the entity's written policies for entering into sales transactions, accounting policies for recording sales transactions, and internal controls related to sales transactions may further the auditor's understanding of the entity, including the system of internal control. The Committee of Sponsoring Organizations of the Treadway Commission's updated *Internal Control—Integrated Framework* (2013 COSO framework)[37] acknowledges that regulatory bodies may require documentation of entity controls in order to meet their objectives. In the absence of controls documentation, it is difficult to identify, confirm, and test controls and evaluate their consistent operation over time.

2.90 The auditor may decide to further consider management's selection and application of significant accounting policies related to revenue recognition. The auditor may have a greater concern about whether the accounting principles selected and policies adopted are being applied in an inappropriate or biased manner to create a material misstatement of the financial statements.

Discussion Among the Audit Team

2.91 In obtaining an understanding of the entity and its environment, including its system of internal control, AU-C section 315 states that there should be discussion among the audit team. In accordance with paragraph .11 of AU-C section 315, "the engagement partner and other key engagement team members should discuss the susceptibility of the entity's financial statements to material misstatement." This discussion could be held concurrently with the audit team's discussion, as specified by AU-C section 240, about the susceptibility of the entity's financial statements to fraud. In order to enhance the auditor's understanding of the entity and develop an appropriate risk assessment, as part of the engagement team discussion the audit team may

- share knowledge of the different revenue streams, including controls that pertain to sales transactions.
- exchange information regarding any changes to the revenue streams as a result of FASB ASC 606 or new performance obligations.
- exchange information about the business risks related to sales transactions.
- exchange ideas about how revenue may be susceptible to material misstatement due to fraud or error.

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[37] COSO. (2013). *Internal Control—Integrated Framework Executive Summary*. AICPA. www.coso.org/documents/990025P_Executive_Summary_final_May20_e.pdf.

Assessing the Risks of Material Misstatement

2.92 Paragraphs .26–.27 of AU-C section 315 state that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should do the following:

- Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, by considering the classes of transactions, account balances, and disclosures in the financial statements. This understanding helps the auditor understand the revenue streams, including any differences in revenue recognition and processes followed for revenue streams. For example, the auditor may determine, as part of performing inquiries with the entity's sales personnel, that the entity enters into certain contracts where they arrange for another party to provide goods or services promised to a customer. In this case, the auditor may identify risks of material misstatement for this revenue stream related to the entity potentially acting as an agent, although this risk does not apply to other streams.
- Assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions. For example, the auditor may determine, as part of requesting and inspecting the entity's policies for sales transactions with customers, that the entity's policies are weak and inconsistently communicated. In this case, the auditor may identify risks of misstatement that relate to multiple assertions within different revenue streams.
- Relate the identified risks to what can go wrong at the relevant assertion level, taking account of relevant controls that the auditor intends to test. For example, the auditor may identify a risk related to the accuracy of revenue, in that the entity may incorrectly record revenue for the gross amount of consideration instead of the net fee or commission it retains after paying the other party their portion of the consideration.
- Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement. For example, the inherent complexity in determining the amount of revenue to record in a given class of transactions—such as the complexity created by the existence of multiple performance obligations—could increase the likelihood of misstatement related to that class of transaction.

2.93 Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design and implementation of controls, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed. If the implementation of FASB ASC 606 could affect materiality assessments in the current or in prior periods, audit planning will need to include a strategy as to how that issue will be addressed. The implementation of FASB ASC 606 could also affect the treatment of any prior-year waived adjustment amounts if the implementation causes changes in the reported financial amounts.

Identification of Significant Risks

2.94 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). In the transition period and beyond, aspects of the entity's application of FASB ASC 606 will continue to give rise to a presumed significant risk.[38] One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk (before the consideration of controls) to determine whether the nature of the risk, the likely magnitude of the potential misstatement (for instance, the possibility that the risk may give rise to multiple misstatements), and the likelihood of the risk occurring are such that they require special audit consideration.

2.95 Paragraphs .28–.30 of AU-C section 315 provide planning guidance on identifying and responding to significant risks. Specifically, paragraph .30 states the following:

> If the auditor has determined that a significant risk exists[39] the auditor should obtain an understanding of the entity's controls, including control activities, relevant to that risk and, based on that understanding, evaluate whether such controls have been suitably designed and implemented to mitigate such risks.

2.96 Paragraph .22 of AU-C section 330 also states the following performance requirement regarding identified significant risks:

> If the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures should include tests of details.

2.97 Paragraph .A58 of AU-C section 330 provides guidance regarding further audit procedures pertaining to significant risk in the context of a revenue-related example. Specifically,

> [p]aragraph .22 requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, a risk may exist that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or

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[38] Peer review findings have identified misunderstanding and misapplications of this technical term. For additional guidance on this term and its use see AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit*. See also paragraph .27 of AU-C section 240.

[39] It is important to note that a presumption exists that revenue is a significant risk.

by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts but also to confirm the details of the sales agreements, including date, any rights of return, and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of nonfinancial personnel in the entity regarding any changes in sales agreements and delivery terms.

2.98 In addition, paragraph .15 of AU-C section 330 states that "[i]f the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor should test the operating effectiveness of those controls in the current period."[40]

2.99 Paragraph .26 of AU-C section 240 states that when identifying and assessing the risks of material misstatement due to fraud, the auditor should, based on a presumption that risks of fraud exist in revenue recognition, evaluate which types of revenue, revenue transactions, or assertions give rise to such risks. Paragraph .46 of AU-C section 240 specifies the documentation required when the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. Paragraph .27 of AU-C section 240 states that

> The auditor should treat those assessed risks of material misstatement due to fraud as significant risks and, accordingly, to the extent not already done so, the auditor should obtain an understanding of the entity's related controls, including control activities, relevant to such risks, including the evaluation of whether such controls have been suitably designed and implemented to mitigate such fraud risks.

Accordingly, the auditor may identify one or more significant risks related to revenue.

2.100 If considered a fraud risk, revenue recognition is considered a significant risk, but even if not a fraud risk, a revenue recognition assertion or assertions may be assessed as a significant risk if the factors mentioned earlier are present. See further discussion in the section of this chapter titled "Consideration of Fraud as it Relates to Revenue."

Specific Audit Considerations Over Revenue Recognition

Side Agreements

2.101 Side agreements may be used to alter the terms and conditions of contracts to entice customers to accept the delivery of goods and services. They may create performance obligations or uncertainties relating to financing arrangements or to product installation or customization that may relieve the customer of some of the risks and rewards of ownership and indicate that the customer does not control the goods or services, therefore precluding the recognition of revenue. Frequently, side agreements are hidden from the entity's board of directors and outside auditors, and only a few individuals within an

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[40] In areas that are not significant risks, paragraph .14 of AU-C section 330 permits testing of controls at least once in every third audit if controls have not changed.

entity are aware that they exist. This makes it difficult for an entity to identify all the performance obligations in a contract.

2.102 Side agreements appear to be prevalent in high-technology industries, particularly the computer hardware and software segments.

Channel Stuffing

2.103 Distributors and resellers sometimes delay placing orders until the end of a quarter in an effort to negotiate a better price on purchases from suppliers that they know want to report good sales performance. This practice may result in a pattern of increased sales volume at the end of a reporting period. This is different from an unusual volume of sales to distributors or resellers, particularly at or near the end of the reporting period, which may indicate channel stuffing. Channel stuffing (also known as *trade loading*) is when suppliers try to boost sales by inducing distributors to buy substantially more inventory than they can promptly resell. Inducements to overbuy may range from deep discounts on inventory to threats of losing the distributorship if the inventory is not purchased. Discounts, rebates, refunds, credits, and price concessions are examples of variable consideration, which impact the transaction price and therefore the revenue recorded. Channel stuffing without appropriate consideration and accounting for sales returns in an entity's estimation of the transaction price (subject to the constraint in FASB ASC 606), is an example of overstating the reported amount of revenue. Channel stuffing may also be accompanied by side agreements with distributors that essentially negate some of the sales by providing for the return of unsold merchandise beyond the normal sales return privileges. Even when there is no evidence of side agreements, channel stuffing may indicate the need to increase the expected value of sales returns above historical experience. In some cases, channel stuffing may even preclude the ability to make reasonable and reliable estimates of product returns, and thus an entity may not be able to conclude that it is probable there will not be a significant reversal in the cumulative amount of revenue before the return right expires.[41] Note: The inability to make reasonable and reliable estimates of product returns is a FASB ASC 605 (SFAS 48) concept. Product returns are considered to be variable consideration; the entity should estimate them and then apply the constraint if there is a significant amount of estimation uncertainty.

Related-Party Transactions

2.104 Related-party transactions require special consideration because related parties may be difficult to identify and such transactions may pose significant "form over substance" issues. Undisclosed related-party transactions may be used to fraudulently inflate earnings. Examples include recording sales of the same inventory back and forth among affiliated entities that exchange checks periodically to "freshen" the receivables and sales with commitments to repurchase that, if known, would preclude recognition of revenue. Although unusual material transactions, particularly close to year end, may be an indicator of related-party transactions, a series of sales executed with an undisclosed

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[41] Refer to SEC Staff Auditing Bulletin (SAB) No. 104, Topic 13, *Revenue Recognition*, for further current information on channel stuffing. Although SEC SABs are directed specifically to transactions of public companies, management and auditors of nonpublic entities may find this guidance helpful in analyzing revenue recognition matters. In light of the new revenue recognition standard, the future of SAB Topic 13 is unknown. Be alert for updates regarding this issue.

party that individually are insignificant but in total are material may also indicate related-party transactions.

2.105 AU-C section 550, *Related Parties* (AICPA, *Professional Standards*), establishes requirements and provides guidance on procedures to obtain audit evidence on related-party relationships and transactions that should be disclosed, in accordance with FASB ASC 850-10. It is important to note that the substance of a particular transaction may be significantly different from its form. Related-party transactions have been used to perpetrate financial statement reporting fraud and, as such, often create a "red flag" for auditors. As stated in paragraph .A2 of AU-C section 550, "financial statements prepared in accordance with GAAP generally recognize the substance of particular transactions rather than merely their legal form." Furthermore, paragraph .03 of AU-C section 550 states that "Many related party transactions are in the normal course of business." However, transactions with related parties may be motivated by fraud or conditions such as the following:

- Lack of sufficient working capital or credit to continue the business
- An overly optimistic earnings forecast
- Dependence on a single or relatively few products, customers, or transactions for the continuing success of the venture
- A declining industry characterized by a large number of business failures
- Excess capacity
- Significant litigation, especially litigation between stockholders and management
- Significant obsolescence dangers because the entity is in a high-technology industry

2.106 Paragraphs .16 and .A22 of AU-C section 550 describe records and documents the auditor may inspect to identify material transactions with parties known to be related and to identify material transactions that may indicate the existence of previously undetermined relationships. Examples of those records or documents include the following:

- Entity income tax returns
- Minutes of meetings of the board of directors and executive or operating committees
- Information supplied by the entity to regulatory authorities
- Contracts and agreements with key management or those charged with governance
- Significant contracts and agreements not in the entity's ordinary course of business
- Third-party confirmations obtained by the auditor (in addition to bank and legal confirmations)
- Specific invoices and correspondence from the entity's professional advisers
- Reports of the internal audit function

2.107 In addition to inquiry, paragraph .24 of AU-C section 550 lists the following procedures that the auditor should perform to obtain satisfaction concerning the purpose, nature, and extent of related-party transactions and their possible effect on revenue recognition:

- Inspect the underlying contracts or agreements, if any, and evaluate whether
  - — the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.
  - — the terms of the transactions are consistent with management's explanations.
  - — the transactions have been appropriately accounted for and disclosed.
- Obtain audit evidence that the transactions have been appropriately authorized and approved.

2.108 Paragraph .09 of AU-C section 550 states that the auditor should consider whether he or she has obtained sufficient appropriate audit evidence to understand the relationship of the parties and the effects of related-party transactions on the financial statements.

Significant Unusual Transactions

2.109 Significant, unusual, or highly complex transactions resulting in revenue recognition that are executed with customers who are not related parties similarly may be given special consideration because they also may pose "substance over form" questions and may involve the collusion of the entity and the customer in a fraudulent revenue recognition scheme.

Nature of Business and Accounting for Revenue

2.110 Improper revenue recognition can occur in any industry. Risk factors are present in particular industries and differ depending on the nature of the product or service and its distribution. Products that are sold to distributors for resale pose different risks than products or services that are sold to end users. Sales in high-technology industries, where rapid product obsolescence is a significant issue, pose different risks than sales of inventory with a longer life, such as farm or construction equipment, automobiles, trucks, and appliances. Under FASB ASC 606, which is void of industry-specific guidelines, companies within the same industry may initially consider accounting for similar transactions differently. However, despite expectations of consistency, the mechanism for achieving consistency remains in process. FASB ASC 606 also increases the need to apply judgment. As a result, the auditor should understand the nature of the entity's business and how transactions and deals are economically structured, in accordance with paragraph .12 of AU-C section 315. The auditor then may be in a position to evaluate whether the entity's accounting policies are consistent with the nature of the business and transactions and compliant with the principles of FASB ASC 606.

2.111 In gaining an understanding of the nature of the entity's business, the auditor usually should obtain an understanding of the factors that are relevant to the entity's revenue recognition, such as the following:[42]

- The appropriateness of an entity's application of revenue recognition principles in the context of the industry in which it operates
- Whether there has been a change in the entity's revenue recognition policy (absent a change in accounting principles) and, if so, why
- The entity's process of accumulating evidence to support estimates and fair valuations used in recognizing revenue
- The entity's practice with regard to sales and payment terms and the existence of implied performance obligations, and whether there are deviations from industry norms or from the entity's own practices, such as the following:
  - — Sales terms that do not comply with the entity's normal policies
  - — Valid customer expectations, created by the entity's customary business practices, that certain goods or services will be included in the arrangement even if they are not explicitly stated in a contract
  - — The existence of longer than expected payment terms or installment receivables
  - — Consideration that is variable in nature exists in certain contracts
  - — The use of nonstandard contracts or contract clauses with regard to sales
  - — Stand-alone selling prices based on non-observable prices or inputs
  - — The lack of a clear method for measuring the entity's progress toward satisfying a performance obligation
- Practices with regard to the shipment of inventory that could indicate the potential for misstatements of revenue or that could have other implications for the audit, such as the following:
  - — The entity's shipping policy is inconsistent with previous years. For example, if an entity ships unusually large quantities of product at the end of an accounting period, it may indicate an inappropriate cutoff of sales. Alternatively, if an entity that normally ships around the clock has stopped shipments one or two days before the end of the current accounting period, it may indicate that management is abandoning its normal operating policies in an effort to manage earnings, which may have broader implications for the audit.
  - — Shipments recorded as revenue are sent to third-party warehouses rather than to customers.

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[42] See paragraph .12 of AU-C section 315.

— Shipments recorded as revenue result from billing for demonstration products that are already in the field.

Potential Accounting Misstatements

2.112 When evaluating whether revenue was recognized properly, auditors should evaluate whether the entity has properly applied the requirements of the applicable financial reporting framework (for example, GAAP). The evaluation of the entity's accounting principles should consider the nature of the entity's goods or services as well as the structure of the contracts. Additionally, auditors may want to consider whether an entity's accounting principles are more aggressive than those of their peers, which may assist the auditors in identifying additional risks of material misstatement.

2.113 The following paragraphs discuss indicators related to sales transactions that may indicate improper revenue recognition. The indicators are categorized into sales that may not be realized as a result of the absence of a contract with the customer, failure to identify the performance obligations, the transaction price is undeterminable, allocation of the transaction price is incorrect, or the entity has not satisfied the performance obligations. The five-step process frames the discussion.

Identify the Contract With the Customer

2.114 Under FASB ASC 606-10-25-2, a contract is defined as an agreement between two or more parties that creates enforceable rights and obligations. The contract should have the approval and commitment of the parties, identify the rights of the parties, identify the payment terms, have commercial substance and it is probable that the entity will collect substantially all of the consideration to which the entity is entitled. Reading and understanding the terms of the sale contract will assist auditors in obtaining an understanding of criteria necessary for a contract to exist. In situations in which it is important to gain an understanding as to whether a contract exists, auditors should consider the risks associated with the existence of nonstandard sales agreements or transactions which are not part of the entity's normal terms and conditions. In addition, auditors will want to evaluate the risks associated with contracts signed in new markets, especially under international laws. Transactions which may create greater risk of material misstatement when evaluating whether a contract exists, or the terms of the contract, may include the following:

- Transactions with related parties[43]
- Transactions involving new products, new customers, international markets, or new sales channels (such as a shift to sales made through a distribution channel)
- Transactions based on oral or implied contracts that are enforceable or based on the entity's customary business practices
- Sales of merchandise that are shipped in advance of the scheduled shipment date without evidence of the customer's agreement or consent or documented request for such shipment
- Sales in which evidence indicates the customer's obligation to pay for the product is contingent on the following:

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[43] See the "Related-Party Transactions" section of this chapter.

— Resale to another (third) party (for example, sale to distributor or consignment sale)

— Receipt of financing from another (third) party

2.115 Contract modifications may have a significant impact on an entity's ability to record revenue. In situations where auditors are evaluating specific contracts, auditors should consider the risk associated with the existence of modified or amended contracts. In situations in which modified or amended contracts exist, it is often important for the auditor to obtain the final contract as well as the various modified agreements when evaluating whether any additional rights or obligations are created through the contract modifications.

Identify the Performance Obligations in the Contracts

2.116 The improper identification of performance obligations in a customer contract may create a risk of material misstatement depending on the nature of the goods or service an entity sells to its customers. In addition to reviewing an entity's contracts with its customers, auditors may consider reviewing an entity's website, marketing materials, and press releases or performing inquiries with an entity's sales representatives when evaluating what performance obligations exist. Auditors often also consider industry practices when evaluating what performance obligations may exist for the entity. Additional considerations may be necessary in situations where implied performance obligations exist or an entity's practice differs from its stated terms. In those situations, auditors may consider additional risks related to form-over-substance considerations.

Determine the Transaction Price

2.117 Contracts where the transaction price is variable may create a heightened risk of material misstatement. Contracts with discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, or penalties may impact the amount of consideration an entity expects to be entitled to in exchange for transferring promised goods or services. The impact of these terms may be based on management's estimate and create a high degree of estimation uncertainty and thus may be subject to management bias. Another risk is that management inappropriately fails to constrain variable revenue for which it is not probable that a significant revenue reversal will not occur.

Allocate the Transaction Price to the Performance Obligations

2.118 When the transaction price is allocated to each performance obligation based on the stand-alone selling price or an estimate, auditors should evaluate management's judgments for bias, in accordance with paragraph .21 of AU-C section 540. Depending on the nature of the entity's goods or services, an observable price based on a stand-alone sale may not be available. In situations where an entity estimates the stand-alone selling price, auditors will ordinarily need to obtain the various assumptions and estimates made by management. The level of estimation uncertainty may increase in situations where the stand-alone selling price is based on non-observable inputs or where variable consideration is allocated to one or more, but not all performance obligations. Auditors should consider the impact any management bias has on the allocation of any discount or the allocation of variable consideration when determining the transaction price.

Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

2.119 In situations where the performance obligation is satisfied at a point in time, auditors may consider the risks associated with revenue being recorded in the incorrect period. Examples of these situations include the following:

- Sales billed to customers before the transfer of control over goods held by the seller (for example, bill-and-hold or ship-in-place sales)[44]
- Shipments in advance of the customer's shipping window
- Shipments made after the end of the period (books kept open to record revenue for products shipped after the end of the period do not satisfy the control criterion for the current period)
- Shipments made to a warehouse or other intermediary location without the instruction of the customer
- Goods pre-invoiced before or in the absence of actual shipment
- Partial shipments made in which the portion not shipped is a critical component of the single performance obligation product
- Sales orders recorded as completed sales

2.120 The assessment of satisfaction of performance obligations over time requires judgment and includes many criteria. Some risks that exist for these types of contracts include the following:

- Management defaults to straight line revenue recognition that does not accurately depict how the customer receives and consumes the benefits of the promise during the contract period.
- When measuring progress toward complete satisfaction of a performance obligation over time, management does not correctly calculate progress to date.
- When measuring progress toward complete satisfaction of a performance obligation over time, the method of measurement is not consistently applied.

Consideration of Fraud as it Relates to Revenue

2.121 AU-C section 240 is the primary source of AICPA authoritative requirements and guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit.[45] AU-C section 200,

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[44] There is specific guidance in FASB ASC 606 that addresses what conditions need to be met in order to recognize revenue for a bill-and-hold transaction.

[45] For audits performed in accordance with PCAOB standards, paragraph .01 of AS 2401, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*), states when performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs .14–.15 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), regarding fraud considerations in addition to the fraud considerations set forth in AS 2401.

Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards (AICPA, *Professional Standards*), and paragraph .05 of AU-C section 240 state that it is an objective of the auditor to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error.

2.122 Two types of misstatements[46] are relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting
- Misstatements arising from misappropriation of assets

2.123 Three conditions are generally present when fraud occurs. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an opportunity for a fraud to be perpetrated. Third, those involved are able to rationalize committing a fraudulent act.

2.124 Paragraph .26 of AU-C section 240 states that there is a presumption that risks of fraud exist in revenue recognition. Material misstatements due to fraudulent financial reporting often result from an overstatement of revenue, but may also result from an understatement of revenue. Therefore, the auditor ordinarily presumes that there is a risk of material misstatement due to fraud relating to revenue. (See paragraph .26, appendix A, and appendix B of AU-C section 240 for examples arising from fraudulent financial reporting.)

2.125 Examples of fraud risks relating to improper revenue recognition include, but are not limited to, the following:

- Management override of entity controls over revenue recognition
- Premature revenue recognition
- Recording fictitious revenue
- Improperly shifting revenue to an earlier or later period
- Improperly using a portfolio approach to mask the results of an individual contract or group of contracts with unfavorable results
- Not recognizing unsigned or oral contracts or contracts implied by the entity's customary business practices
- Not identifying all material performance obligations
- Manipulating estimates used in accounting for revenue, including, but not limited to
  - — variable consideration, including constraining estimates of variable consideration and returns
  - — stand-alone selling price of bundled goods or services or both

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

2.126 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraph

[46] See paragraph .03 of AU-C section 240.

.15 of AU-C section 240. The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud will ordinarily include a consideration of the known external and internal factors affecting the entity that can (*a*) create incentives or pressures, or both, for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management or others to rationalize committing fraud. Assessment of fraud risk and communication among the audit team members about the risks of material misstatement due to fraud should continue throughout the audit, in accordance with paragraph .32 of AU-C section 315 and paragraphs .15 and .25 of AU-C section 240.

2.127 In addition to the discussion points noted previously, the fraud discussion should also include the following, in accordance with paragraph .15 of AU-C section 240:

- The risk of management override of controls
- Consideration of circumstances that might be indicative of earnings management or manipulation of other financial measures, and consideration of the practices that might be followed by management to manage earnings or other financial measures that could lead to fraudulent financial reporting
- The importance of maintaining professional skepticism throughout the audit regarding the potential for material misstatement due to fraud
- How the auditor might respond to the susceptibility of the entity's financial statements to material misstatement due to fraud

As fraud can be perpetrated in many different ways, paragraph .26 of AU-C section 240 states that the auditor should understand and discuss the different types of revenue transactions of the entity and how the different types of transactions could be fraudulently manipulated.

The Importance of Exercising Professional Skepticism

2.128 Professional skepticism should be exercised when considering the risks of material misstatement due to fraud or error.[47] Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor conducts the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud or error could be present, regardless of any past experience with the entity and the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement has occurred. Some specific procedures that can be used to enhance audit effectiveness include varying the intensity of audit procedures applied to financial statement items (designing a "deeper dive"), varying the mix of audit procedures from time to time, assigning different experienced staff, and conducting effective brainstorming sessions with fraud specialists.

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[47] Professional skepticism is characterized as "an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence." See paragraphs .14 and .17 of AU-C section 200 as well as paragraph .12 of AU-C section 240.

IFRS 15 Versus FASB ASC 606

2.129 When reporting involves both GAAP and International Financial Reporting Standards (IFRS), some differences in the standards or interpretation could be important. For example, the collectibility threshold for revenue recognition under IFRS 15 has been interpreted as "more likely than not" in international practice, but the term "probable" in FASB ASC 606 has been interpreted at a higher level than "more likely than not." Other differences between the two sets of standards include interim disclosure requirements, early application and effective date, reversal of impairment losses, and nonpublic entity requirements. These differences, although relatively minor, may need to be considered and reconciled in the auditing and disclosure process when an entity prepares financial statements under U.S. GAAP and IFRS. Refer to appendix A, "Comparison of IFRS 15 and Topic 606," or the Basis for Conclusions of IFRS 15 for more information on these differences. Such differences may also be important to note in principal auditor communications in a group audit situation.

The Role of Controls Over Financial Reporting in Revenue Recognition

2.130 Paragraph .03 of AU-C section 315 states that an auditor should obtain an understanding of the entity and its environment, including its system of internal control:

> The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

2.131 In obtaining an understanding of the entity's internal control, the principles in the COSO framework[48] provide a useful approach for entities. These principles are referred to by their number throughout this guide. Additional guidance regarding the assessment of the entity's internal control over financial reporting during the transition phase can be found in the section of this chapter titled "Auditing Considerations in the Adoption and Transition to FASB ASC 606."

Control Environment[49]

2.132 Principle 1 of the COSO framework requires the entity to demonstrate "a commitment to integrity and ethical values.[50] Setting the right "tone at the top," as well as setting expectations for recognizing revenue and complying with the provisions of FASB ASC 606 are critical to ensuring appropriate

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[48] When using a COSO framework, the 2013 framework is relevant because previous guidance has now been superseded. Entities may also adopt another comprehensive framework such as COCO (Canada) or the Turnbull Report (UK), as permitted by AU-C section 315. Auditors may need to adapt their approach to the framework adopted by the auditee.

[49] The 17 principles enumerated in the COSO framework are summarized in appendix C, "Internal Control Components," of AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit*.

[50] The 17 principles enumerated in the COSO framework are summarized in appendix C, "Internal Control Components," of AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit*.

and effective controls. Pressures by senior management to recognize revenue in advance of the satisfaction of a performance obligation can undermine an otherwise robust system of internal control. Senior management sets the tone for consistent application of the sound and unbiased judgments required under FASB ASC 606.

2.133 Principle 2, "Exercises Oversight Responsibility," of the COSO framework requires an entity's board of directors or, alternatively, the governance function to exercise oversight of the development and performance of the entity's internal controls. To meet this requirement regarding revenue recognition, the board of directors will usually need adequate resources and authority to fulfill their role of being informed, vigilant, and effective overseers of the financial reporting process and the entity's internal controls. This includes being informed of changes in control structure due to FASB ASC 606, as well as changes related to new contracts and customer relationships.

2.134 Principle 3, "Establishes Structure, Authority, and Responsibility," of the COSO framework requires management to establish reporting lines and appropriate authorities not only among its revenue recognition implementation team but also with the board of directors or governance function.

Internal Audit Considerations

2.135 The COSO framework recommends that entities maintain an effective internal audit function that is adequately staffed with qualified personnel appropriate to the size and nature of the entity. To enhance the objectivity of the internal audit function, the chief internal auditor will ordinarily have direct access and report regularly to the entity's chief executive officer and to the audit committee or other designated governance group. An important responsibility of the internal audit function in many cases is to monitor the performance of an entity's controls. Internal auditors may be involved in monitoring management's ongoing implementation of FASB ASC 606 and thus will likely be familiar with the new requirements. Additionally, internal auditors and management may begin to develop plans to monitor the effectiveness of new or revised controls that entities will likely employ as a result of adopting FASB ASC 606. Although smaller entities may not have the resources to have a full-time internal auditor or staff, some are able to achieve some of the objectives of an internal audit function through the actions of management or by hiring part-time resources.

Assignment and Evaluation of Personnel

2.136 Principle 4, "Demonstrates Commitment to Competence," of the COSO framework, emphasizes the importance of being able to attract, develop, and retain competent individuals in alignment with the financial reporting objectives. All entities should have appropriate resources to evaluate revenue arrangements and properly apply the principles of FASB ASC 606. Personnel needs may differ according to the complexity of revenue recognition for that entity. The needs might be satisfied through a designated accounting policy and controls function or through a relationship with a qualified service provider possessing resources with sufficient training and competence. Because FASB ASC 606 provides a principles-based accounting model, more judgment will likely be involved in processing routine transactions. Therefore, entities may need to continually reassess the impact of the required financial reporting competencies and revise training, retention, and recruitment appropriately.

2.137 Principle 5 of the COSO framework also addresses the process of managing personnel involved in the financial reporting process, including holding individuals accountable for their internal control responsibilities. Management may need to reassess the performance management processes for those individuals who will be performing new or revised controls in conjunction with adopting FASB ASC 606.

Risk Assessment

2.138 An entity's preliminary consideration of the risks associated with the implementation of FASB ASC 606 may be helpful in anticipating and minimizing issues that may be identified in the transition and going-forward accounting process. Additional lead time in anticipating and addressing these issues will likely create a smoother and more efficient implementation for entities and auditors.

2.139 Principles 6 and 7 in the COSO framework are "The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives," and "The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed," respectively. They relate specifically to an entity's recognition and response to risks of financial reporting. For many entities, FASB ASC 606 may pose risks of fairly presenting current and historical revenue. Entities are expected to update risk assessments as a result of considering the effect of FASB ASC 606 on an entity's internal control over financial reporting and financial reporting objectives. Because this is a major change in accounting guidance for many entities and principle 9, "The organization identifies and assesses changes that could significantly impact the system of internal control," relates to management responding to changes, it is likely that the change in the revenue recognition accounting will create new financial reporting risks that the entity may identify and subsequently design controls to address. This also relates to the design of controls in principles 10, "The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels," and 12, "The organization deploys control activities through policies that establish what is expected and in procedures that put policies into action." Through the risk assessment process and the resulting financial reporting risks that are identified, the absence or weakness in design or implementation of an entity's controls over financial reporting risks may often indicate a "gap" in the controls design or effectiveness, resulting in a control deficiency of some magnitude.

2.140 For auditors, revenue recognition is a presumed fraud and significant risk, as described in AU-C section 240, and relates to principle 8 of the COSO framework, "The organization considers the potential for fraud in assessing risks to the achievement of objectives." It is critical that the perspectives of management and auditors be aligned with regard to this issue. When revenue recognition is not a fraud risk, revenue recognition still holds an important role in financial statement preparation, as revenues may have a central role in forming a benchmark from which the reasonableness of other financial statement amounts is measured.

2.141 During the transition to and post-adoption implementation of FASB ASC 606, most entities will establish controls to ensure complete and accurate financial reporting of revenues. Such controls can help control audit costs of testing the data used and satisfying the assertions regarding revenue.

Control Activities

2.142 The COSO framework defines control activities as "the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out." Control activities normally flow from the entity's risk assessment process, and the failure to design controls to address identified risks in many cases will result in communications to management and governance regarding significant deficiencies and material weaknesses. Controls may be preventive or detective in nature and may encompass a range of manual and automated activities such as authorizations and approvals, verifications, reconciliations, and business performance reviews. Although a mixture of different types of controls is considered desirable, a specific mixture is not required.

2.143 FASB ASC 606 is a principles-based standard that will require management to exercise more judgment and potentially make more estimates or exercise more influence in the revenue recognition process. It is critical that entities have an effectively designed system of internal control to address this increase in subjectivity. The following table discusses key considerations when evaluating an entity's control activities. The examples are not meant to be all-inclusive.

Five-Step Model	***Considerations That Management May Need to Address With New or Amended Controls and That the Auditor, in Turn, May Need to Evaluate and Perhaps Test (for Example, When Following a Controls Reliance Strategy)***
Step 1: Identify the contract with the customer	**Controls over:** • Identifying contracts (whether written or unwritten) that meet the criteria defined in FASB ASC 606-10-25-1 • Reassessing arrangements not initially meeting the criteria of a contract in accordance with FASB ASC 606 as significant changes may occur in the underlying facts and circumstances • Assessing management's and the customer's commitment and ability to perform under the contract • Ensuring payment terms are properly considered • Assessing the collectibility criterion • Evaluating whether combined or individual contracts meet the various criteria specified in FASB ASC 606-10-25-9 • Evaluating contract modifications

(continued)

Five-Step Model	***Considerations That Management May Need to Address With New or Amended Controls and That the Auditor, in Turn, May Need to Evaluate and Perhaps Test (for Example, When Following a Controls Reliance Strategy)***
Step 2: Identify performance obligations	**Controls over:** • Identifying performance obligations, including those explicitly stated in the contract and those that may be implied based on customary business practices • Evaluating whether a promised good or service is distinct, particularly within the context of the contract • Evaluating whether a series of goods or services should be treated as a single performance obligation
Step 3: Determine the transaction price	**Controls over:** • Estimating the amount to which the entity expects to be entitled (that is, the transaction price), including any variable consideration. When valuation consultants are hired, it is normally expected that controls are in place to ensure their competence and objectivity • Evaluating whether any portion of variable consideration should be constrained • Determining the fair value of noncash consideration • Identifying and measuring whether there is a significant financing component in the contract • Determining the accounting for consideration payable to a customer
Step 4: Allocate the transaction price	**Controls over:** • Estimating the stand-alone selling price, including the maximizing the use of observable inputs in that process • Determining the appropriate transaction price allocation, including variable consideration and discounts
Step 5: Satisfaction of performance obligations	**Controls over:** • Determining whether performance obligations are satisfied at a point in time or over time • Measuring progress toward complete satisfaction of a performance obligation that is satisfied over time (that is, the input and output methods) • Recognizing revenue only when (or as) control is transferred to the customer

In addition, controls may be designed to facilitate interim reporting and the generation of required disclosures.

Information and Communication

2.144 FASB ASC 606 requires more information and data about the entity's activities than under current guidance for management to be able to properly account for contracts with customers and to prepare the necessary disclosures. This may often include using internal and external information to make appropriate judgments and estimates where necessary. The process by which information is gathered across the organization is fundamental to any effectively designed system of internal control. Gathering the necessary information to apply FASB ASC 606 may require seamless communication across the various functions of the organization.

2.145 Because historical data may be needed to assess the status of existing contracts not fully satisfied in the prior reporting periods, entities are advised to be mindful of what data needs to be retained to reliably restate financial statements at the time of the transition. In addition, the information needs regarding required disclosures will also need to be considered. Given the different data retention and retention formats chosen by entities, the availability of the data in useable form when needed may greatly affect the cost and complexity of transitioning to FASB ASC 606. An early assessment of information needs is likely to be valuable.

Monitoring

2.146 The evaluation process of controls functionality is a group effort that may be performed by entity leadership, internal auditors, or others. Under the COSO framework, the independent auditor is not a part of the entity's process of evaluating its system of internal control. The functionality of an entity's system of internal control is a fluid process, impacted by changes in rules, regulations, the business environment, and evolving technology. As controls related to FASB ASC 606 begin to change, entity leadership and internal auditors may need to modify their monitoring activities to ensure that controls maintain their functionality.

2.147 Principles 16 and 17 in the COSO framework provide guidance in two areas: (1) evaluation of control designs and functionality and (2) communication of deficiencies in internal control design and functionality to management and the board of directors or governance. The following list outlines principles 16 and 17 and describes some factors the organization and external auditors may need to consider when applying these principles.

- *Principle 16*: "The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning."
  - — The organization may need to reconsider its monitoring approach in order to ensure that the five steps for recognizing revenue under FASB ASC 606 are appropriately integrated into the financial reporting process.
  - — External auditors will usually want to consider how the organization has changed its evaluation process to adopt FASB ASC 606 related to contractual performance and satisfaction, contractual scope modifications,

identification of performance obligations and assessment of their materiality (either quantitatively, qualitatively, or both), and estimates involving the probability surrounding variable consideration.

- *Principle 17*: "The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate."
  - — The organization may need to modify its preventative and corrective action processes in order to ensure that impacted parties understand any control remediation steps related to adopting FASB ASC 606.
  - — External auditors will usually want to consider the organization's control environment and process changes in order to be able to properly identify deficiencies in controls, if any, and ascertain the degree of significance, including when to aggregate deficiencies to evaluate severity.

Obtaining Audit Evidence

2.148 AU-C section 330 includes requirements for the auditor to design and implement responses to the risks of material misstatement identified at the financial statement level in the risk assessment process. FASB ASC 606 in most cases will require a fresh look at assessments related to revenue and related disclosures. The auditor designs procedures whose nature, timing, and extent are based on, and are responsive to, the assessed risks of material misstatement at the relevant assertion level. In designing the procedures, the auditor considers the type of audit evidence necessary. The more persuasive evidence the auditor can obtain, the lower the auditor's assessment of remaining risk. To obtain more persuasive audit evidence, the auditor can increase the quantity of evidence or increase the quality by obtaining more relevant or more reliable evidence.

2.149 The evidence to respond to risks of material misstatement includes the presumption that risks of fraud exist in revenue recognition as noted in AU-C section 240. Overall responses include assigning and supervising personnel appropriately and incorporating an element of unpredictability into the nature, timing, and extent of audit procedures. Additionally, and particularly relevant for auditing revenue, the auditor can evaluate the selection and application of accounting policies, especially those related to subjective measurements and complex transactions, because they may be indicative of fraudulent financial reporting or potential management bias.

2.150 The financial reporting risks identified are one basis for developing further audit procedures. Substantive procedures and tests of controls can be utilized, either individually or in combination, to develop the appropriate audit approach. Ultimately, the audit evidence obtained during the audit is cumulative and evaluated together to form the audit opinion.

Types of Substantive Procedures

2.151 Various types of substantive procedures may be used in addressing the relevant assertions for revenue recognition. The inherent risk assessment and the assessment of control risk regarding the assertions in revenue, when considered together, form an assessment of the *risk of material misstatement* from which the auditor designs other substantive procedures to address the audit risk in revenue. The following paragraphs discuss substantive procedures that may be useful in auditing revenue.

2.152 *Vouching*. The final (executed) contract may provide sufficient evidence to assess proper revenue recognition. The vouching of contract terms to the amount of revenue booked may be set up as a sample or all contracts may be subject to testing. Some audit procedures will likely need to be applied to any portion of contracts not sampled or otherwise selected for vouching that could, by themselves or in combination with other misstatements, lead to a material misstatement. The auditor will ordinarily select any individual contracts for examination if, due to their size or risk characteristics, they could result in a misstatement greater than tolerable misstatement or performance materiality (either quantitatively, qualitatively, or both) or aggregate with other misstatements to breach these thresholds.

2.153 *Tests of Details and Cutoff Tests*. Tests of details can be used to assess cutoff by testing transactions before and after the cutoff date. If cutoff controls are determined to be effective, the extent of testing for substantive cutoff procedures can usually be reduced. To test the accuracy or valuation of sales transactions, particularly when complex revenue recognition issues are involved, the revenues balance itself may be sampled to assess the accuracy of the determination of revenue. After considering inherent risk, control risk, and analytical procedures risk,[51] the substantive sample size in most cases will be responsive to the remaining risk of misstatement and the tolerable and expected misstatement for the account. As noted in the section of this chapter titled "General Audit Considerations Over Revenue Recognition," the existence of revenue may also be addressed by the audit procedures surrounding cash receipts and accounts receivable.

2.154 *Confirmations*. External evidence such as confirmation of the contract terms with customers is stronger than internal documentation alone. Auditors in many instances confirm a sample of accounts receivable, unless certain conditions are met. However, confirmations may go beyond account balances and may include terms of the agreement and the presence or absence of certain conditions such as side agreements or implicit agreements. AU-C section 240 suggests that the confirmation of contract terms may mitigate fraudulent financial reporting.

2.155 *Analytical Procedures.* These procedures may be performed in the planning, performance, and final review phases of the audit and may be used as a substantive testing procedure. However, analytical procedures may not be as effective or efficient as a test of details in providing the desired level of assurance for some assertions such as valuation or accuracy of specific contracts when a variety of contractual types exist for an entity.

2.156 Analytical procedures generally involve the comparison of recorded amounts, or ratios developed from the recorded amounts, to expectations developed by the auditor. They may also be used to confirm expected relationships

[51] The aforementioned risks measure the effectiveness of these procedures in detecting misstatement. Substantive tests may then be designed to achieve an overall low risk of undetected misstatement.

between production or purchases with sales and cost of sales and also with resulting balances in inventories. In frauds involving revenue or inventories, analytical procedures can be effective in identifying unusual or inexplicable relationships. When these analyses are used as substantive audit evidence, the auditor should evaluate the reliability of the data used in such analyses.[52]

2.157 An objective of analytical procedures in planning is to identify specific risks such as unusual patterns of sales within and between periods. Examples of such patterns include unusual patterns of sales around the cutoff date or unusual patterns of returns and allowances. For example, a strong negative result in a revenue or related returns account after period end may indicate that higher than normal volumes of sales are being returned (for example, bill-and-hold sales). Management override of controls may also be an explanation for unusual patterns or trends. Corroborating evidence can confirm management's explanations for unusual patterns.

2.158 Any time unexpected variances are identified, other evidence may be obtained to support management's responses. When revenue recognition is a significant risk of material misstatement, substantive analytical procedures should be supplemented with evidence from control assessments, and if controls are not tested and relied on, substantive tests of details should also be performed (see paragraph .30 of AU-C section 315 and paragraph .22 of AU-C section 330).

Potential Issues in Obtaining Audit Evidence

2.159 A challenge is the sufficiency and appropriateness of audit evidence supporting revenue recognition. Evidence indicating that revenue may have been improperly recorded include

- inconsistent, vague, or implausible responses from management or employees to inquiries about sales transactions or about the basis for estimating sales returns.
- documents to support sales transactions or journal entries affecting revenue accounts are missing.
- bills of lading that have been signed by entity personnel rather than a common carrier.
- documents such as shipping logs or purchase orders have been altered.

Also refer to the section of this chapter titled "Obtaining Audit Evidence."

Audit Evidence Related to the Five Steps of Revenue Recognition Under FASB ASC 606

2.160 AU-C section 500 describes procedures auditors may perform—including observations, confirmation, reperformance, and analytical procedures—in order to obtain evidence. The level of evidence necessary to support the amount of revenue recorded during a period is likely to be based on the risks associated with the assertions and class of transactions. The higher the risk, the greater the extent or quality of evidence is likely necessary. In

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[52] The aforementioned risks measure the effectiveness of these procedures in detecting misstatement. Substantive tests may then be designed to achieve an overall low risk of undetected misstatement.

engagements with higher assessed risks, an audit plan that includes evidence gathered through inspection, observation, and external confirmations may be necessary in order to reduce the potential for undetected misstatements to an acceptable (low) level. In the period of implementation and transition, a higher risk may exist regarding open contracts because of management's revised judgments concerning the treatment of these items, resulting in the need for more audit evidence.

2.161 AU-C section 500 makes it clear that inquiry alone is usually insufficient evidence to support a significant assertion or assumption. Inquiry usually needs to be accompanied by other supporting or corroborating evidence such as observation or tests of details. It can be challenging to identify additional sources of evidence in some situations (for example, situations involving management intentions), but past experience with management and observing corroborating management actions can also be supportive of an assertion.

2.162 When obtaining direct evidence is challenging, (for example, when assessing the reliability of management's future intentions or when management assertions are critical even though other support is obtained) the auditor may consider making these intentions and assumptions part of the management representation letter in addition to obtaining other evidence, as necessary, to support management's assertion. See the section of this chapter titled "Management Representations" for more information on this topic. The following paragraphs walk through audit evidence that may be obtained at each step of revenue recognition under the new guidance.

Identify the Contract With a Customer

2.163 In order to have a contract with a customer, an entity is expected to provide evidence that the contract was approved and has the commitment of the parties, that the rights of the parties are identified, the payment terms are identified, the contract has commercial substance, and that collectibility of substantially all of the transaction price to which the entity is entitled is probable.[53] Oral contracts present challenges when collecting sufficient and appropriate evidence to recognize revenue. When evaluating the evidence provided, auditors may inspect various purchase orders or contracts based on the entity's customary business practice. In situations where contracts are amended, obtaining a complete and accurate understanding, supported by source documents, may be necessary when evaluating whether an entity has sufficient audit evidence supporting their assertion that a contract with a customer exists. In some industries where contracts take the form of executed contracts between the parties, auditors may inspect, observe, or confirm the various elements in executed contracts between the parties to ensure the contract has validity. Not all arrangements will meet all five of the revenue recognition criteria. For example, master supply agreements may constitute a signed contract but may not pass the first step if payment terms are not defined.

Identify the Performance Obligations in the Contract

2.164 A contract with a customer generally identifies the goods or services that an entity promises to transfer to a customer. However, the performance obligations identified in a contract with a customer may also include promises that are implied by an entity's customary business practices, published policies,

[53] This guidance is based on FASB ASC 606-10-25-1.

or specific statements if, at the time of entering into the contract, those promises create a valid expectation by the customer that the entity will transfer a good or service to the customer.

2.165 Obtaining evidence of all implied performance obligations in a contract with a customer may be challenging for the auditor. It is important to obtain a sufficiently detailed understanding of the nature of the entity's business, their customary business practices, and published policies such that the auditor is able to identify all performance obligations. This understanding may be obtained by performing the following:

- Visiting and reading content on the entity's website
- Reading the entity's published policies
- Making inquiries of individuals from the entity's various departments in addition to the accounting department (for example, sales, marketing, legal, information technology)
- Obtaining and reading analyst reports
- Understanding the policies and practices of the entity's competitors
- Understanding industry, regulatory, and other external factors affecting the entity's business
- Confirming the terms of significant contracts

2.166 The entity will often need to determine whether the good or service is distinct within the context of the contract. A good or service that is promised to a customer may be distinct if specific criteria are met (see the section "Step 2: Identify the Performance Obligations in the Contract"). Evidence the auditor may obtain supporting the assumption that a good or service is distinct includes, but may not be limited to, the following:

- The entity regularly sells the good or service on its own or with other readily available resources
- Evidence that a good or service is delivered on its own (for example, prior to the delivery of other goods or services)
- Evidence that the customer could generate economic benefit from the individual goods or services by using, consuming, selling, or holding those goods or services

2.167 Evidence the auditor may obtain supporting the assumption that a good or service is not distinct includes, but may not be limited to, when the entity provides a significant service of integrating the goods and services (that may be individually distinct) into a combined output for which the customer has contracted.

2.168 In some contracts, there may be customer options for additional goods and services. Selected distribution, such as when a discount is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market[54] is an example of evidence that the customer may only benefit from the option if exercised (that is, the benefit is not offered broadly to all customers, as is the case with postcards and email discounts).

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[54] Currently there are diverse views on whether a discount on a past purchase is automatically a material right. This guidance is in accordance with FASB ASC 606-10-55-42.

Determine the Transaction Price

2.169 As explained in FASB ASC 606-10-32-2, the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales tax). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

2.170 As explained in FASB ASC 606-10-32-6, the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. As part of understanding the entity, in accordance with AU-C section 315, the auditor will usually obtain an understanding of variable consideration offered to the customer and how this affects the transaction price. Auditors may identify contradictory evidence when reviewing the entity's website, emails offering special pricing, mailing lists, and so on. For example, the entity's return policy may be for a certain period of time and only with a receipt; however, the entity may regularly accept returns without a receipt outside of the defined return period. The auditor will usually consider how the entity has considered deviations from its policy in its estimate of variable consideration. The auditor usually also considers any significant historical contra-revenue transactions to the entity's sales and understand how the entity accounts for such items currently.

2.171 When the entity has reassessed its estimates of variable consideration at the end of the reporting period, the auditor will often consider any supporting or contradictory evidence indicating whether there may have been a change in the amount of consideration received by the entity (for example, a significant increase in contra-revenue amounts in the preceding period).

Any constraint related to variable consideration will normally be considered. This includes

- the entity's historical transactions and the total transaction price received from the customer upon completion of the contract.
- external factors that may influence the total consideration received from the customer, including the amount of time until the contingency is resolved.

Allocate the Transaction Price to the Performance Obligations in the Contract

2.172 As noted previously, paragraph .A2 of AU-C section 500 states that

> [a]lthough inquiry may provide important audit evidence and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor is inquiry alone sufficient to test the operating effectiveness of controls.

A contractually stated price or a list price for a good or service may not be presumed to be the stand-alone selling price. When gathering evidence of the stand-alone selling price, an inspection or observation of features of the contract between the parties may be appropriate.

2.173 Evidence supporting the stand-alone selling price may be based on an inspection of various arrangements, noting the reference to the price of an item when sold separately. The extent of evidence needed may vary based on the assessed risk of material misstatement associated with the specific class of transactions or revenue stream.

2.174 In many instances, audit evidence to support the stand-alone selling price of an element in a multiple-element arrangement may be obtained from an evaluation of a vendor's historical sales of products and services. The following are examples of factors that may be useful in evaluating a vendor's product and service pricing history:

- Similarity of customers
  - Type of customer
- Similarity of products or services included
  - Types of products or services
  - Stage of product life cycle
  - Elements included in the arrangement
- Similarity of license economics
  - Length of payment terms
  - Economics and nature of the license arrangement

Recognize Revenue When or as the Entity Satisfies a Performance Obligation

2.175 In situations where client acceptance is a condition that impacts the satisfaction of the performance obligation, evidence of the customer accepting the product or service is usually necessary. In situations with a heightened risk related to whether the performance obligation was satisfied, the auditor may decide to confirm directly with the customer regarding the terms of the contract and the satisfaction of the performance obligations. If uncertainty exists regarding a customer's acceptance after delivery of a good or service, revenue may often not be recognized until acceptance occurs. However, note that FASB ASC 606 is not as restrictive as FASB ASC 605 in prohibiting revenue recognition as it relates to acceptance clauses.

2.176 When evaluating the sufficiency and appropriateness of audit evidence supporting the satisfaction of a performance obligation, evidence may vary based on the nature of the performance obligation. Evidence related to the satisfaction of a performance obligation associated with the delivery of product may be supported through the inspection of shipping documents from third-party carriers. In situations where performance obligations are satisfied though the delivery of services, evidence may consist of the inspection of work orders or timecards.

Auditing Estimates

2.177 Estimates, discussed within AU-C section 540, are pervasive within the new revenue recognition process. Entities may be required to make more estimates and use more judgment than under current guidance. To evaluate the effects of these changes, management will identify areas in which key judgments and estimates will be required. These areas may include identifying the contract and performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price, and allocating the transaction price to each separate performance obligation based on the standalone selling prices.

2.178 The following table illustrates some considerations related to management estimates within the five-step model of FASB ASC 606.

Five-Step Model	***Management Estimates That May Be Required***	***Audit Considerations***
Identify the contract with a customer—contract modifications.[55]	Although it is always required that a contract be approved in order to apply modification accounting, if the entity has not yet determined the price (and it is enforceable), the entity should *estimate* the change to the transaction price using the variable consideration guidance. For a discussion of unapproved contract modifications, see FASB ASC 606-10-25-11.	If using a controls reliance strategy, auditors should apply the requirements in AU-C section 330 to test management's controls around contract modifications. Audit procedures may include evaluating the sufficiency of substantive evidence around approval of modifications to contracts without a final price and determining the collectibility of the contract based on the modified transaction price.
Determine the transaction price—variable consideration	Transaction price is based on the amount to which an entity expects to be entitled. This amount is meant to reflect the amount that the entity has rights to under the present contract. If the consideration promised in a contract includes a variable amount, an entity should *estimate* the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer, subject to a constraint.	FASB ASC 606 created a new method for determining the transaction price by shifting from "fixed and determinable" to estimating variable consideration using either the expected-value or most-likely-amount approaches. Processes, systems, and controls will likely need to transform to support this new approach. Management may develop new controls that incorporate available information, the methods applied and rationale, and the application of the method used to compute

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[55] Other considerations such as collectibility may also result in management estimates. This illustrative table is not intended to be all inclusive.

Five-Step Model	*Management Estimates That May Be Required*	*Audit Considerations*
	For a discussion of variable consideration, see paragraphs 5–9 and 11–14 of FASB ASC 606-10-32.	variable consideration. Management is expected to consider all the information (historical, current, and forecast) that is reasonably available to identify a reasonable number of possible consideration amounts. The information an entity uses to estimate the amount of variable consideration typically would be similar to the information that management uses during the bid-and-proposal process and in establishing prices for promised goods or services. Thus, as part of this control, management may establish a process for connecting accounting with the sales and financial planning departments. When evaluating the reasonableness of an estimation of variable consideration made by an entity, it is often important to evaluate the relevant factors and assumptions that the entity has considered in making the accounting estimate, including the entity's reasons for the particular assumptions. This includes evaluating whether the assumptions made by the entity in making the estimate are based on reasonable assessments of present business circumstances and trends, and the most currently available information; whether they are complete (that is, whether assumptions were made

Five-Step Model	*Management Estimates That May Be Required*	*Audit Considerations*
		about all relevant factors); whether they are supported by reliable information; the range of the assumptions; and the alternatives that were considered but not used, including any reconciliation of information that may be contradictory to the final conclusion. When relying on management's controls, auditors should test them to ensure the consistent application of the selected methodology and the completeness and accuracy of the information used to make the estimate, among other things. When evaluating the reasonableness of the assumptions used to estimate variable consideration, auditors will usually evaluate whether the assumptions are consistent with historical trends and with prior years' assumptions; whether the changes in any assumptions are supported by, or required because of, changes in circumstances or facts; whether assumptions differ from prior years' assumptions when they should; and whether assumptions are consistent with each other and with management's plans, and any other information obtained (for example, evidence obtained via direct confirmation of the terms of an arrangement with a customer). It is important to be alert for transactions

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Five-Step Model	*Management Estimates That May Be Required*	*Audit Considerations*
		whose terms are not consistent with an entity's policies or past practices regarding returns or refunds, particularly those involving side agreements that allow for a right of return that is inconsistent with historical experience. Whenever such policies are unclear, auditors may confirm the terms of the relationship with the customer. If management designs controls that the auditor intends to rely on around the use of inputs and related documentary support for the estimate, such controls should be tested in accordance with AU-C section 330. Inquiries and examination of evidence regarding management's consideration of evidence that was contrary to their ultimate conclusion ordinarily would be performed. Additionally, when testing variable consideration, auditors may need to consider whether other forecast data is available within the organization and the consistency of assumptions among various analyses.

Five-Step Model	*Management Estimates That May Be Required*	*Audit Considerations*
Determine the transaction price—expected value and most likely amount	Choosing and applying the expected-value approach or the most-likely-amount approach is a matter of judgment. FASB indicated that the expected-value approach may be more appropriate when an entity has a large number of contracts with similar characteristics. The expected-value approach does not require an entity to consider all possible outcomes, even if data is available. A limited number of discrete outcomes and probabilities can provide a reasonable estimate of the expected value. The most-likely-amount approach is likely to be more appropriate when the contract has only two possible outcomes. Also, FASB indicated that an entity will always need to estimate the amount of variable consideration to which it will be entitled, except in certain cases for sales-based royalties. For a discussion of the estimation of variable consideration, see paragraphs 8–9 of FASB ASC 606-10-32.	Auditing an entity's selection approach used to estimate variable consideration and its application may require the involvement of valuation professionals. Although entities are expected to consider all information available, it is not necessary to incorporate every outcome—the goal is to predict the expected value. Controls may be established around management's consideration of available information, choice of method, and application of the method in computing variable consideration. Management may establish a policy for applying the expected-value or most-likely-amount approach to ensure consistency for similar types of performance obligations. The election is not a free choice but should be based on the number of possible outcomes and other facts and circumstances. Also, a control or component of a control may be established to ensure the consistent application of the method for a particular performance obligation over time as well as for similar performance obligations within the organization. Absence of the aforementioned control or management override will likely heighten the risk of bias and misstatement. Auditors may also wish to consider whether the selection of some and not all possible outcomes may introduce bias into the assessment.

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Five-Step Model	*Management Estimates That May Be Required*	*Audit Considerations*
Determine the transaction price—constraint of variable consideration	An entity should include in the transaction price the variable consideration only to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. An entity should consider both the likelihood and magnitude of the revenue reversal. For a discussion of constraining estimates of variable consideration, see paragraphs 11–13 of FASB ASC 606-32.	The language within the variable consideration constraint focuses on probable and potentially significant reversals of revenue based on cumulative revenue (not just variable consideration). Consideration of these factors would normally be included within management's new policy. Additionally, auditors in many cases will discuss how entities view the terms "probable" and "significant" and how they have built these views into the processes and controls surrounding their assessments.
Determine the transaction price—updating the *estimate* of the transaction price	When an arrangement includes variable consideration, an entity should update its estimate of the transaction price throughout the term of the contract to depict conditions that exist at each reporting date. This will involve updating both the estimate of the variable consideration and the constraint on the amount of variable consideration included in the transaction price. For a discussion of the reassessment of variable consideration, see FASB ASC 606-10-32-14.	FASB ASC 606 requires updating the estimate of variable consideration. Management may establish a process and related controls to update the estimates. When auditors intend to rely on these controls, they should be tested. Auditors are reminded of the need to seek evidence beyond management inquiry.

Five-Step Model	*Management Estimates That May Be Required*	*Audit Considerations*
Allocate the transaction price—stand-alone selling price	FASB ASC 606 requires an entity to allocate the transaction price to the performance obligations. This is generally done in proportion to their stand-alone selling prices (that is, on a relative stand-alone selling price basis). As a result, any discount within the contract generally is allocated proportionally to all the separate performance obligations in the contract. Under the model, the observable price of a good or service sold separately provides the best evidence of stand-alone selling price. However, in many situations, stand-alone selling prices will not be readily observable. In those cases, the entity should estimate the stand-alone selling price, maximizing the number of observable inputs when making such estimates. For a discussion of the allocation of the transaction price based on stand-alone selling price, see paragraphs 31–35 of FASB ASC 606-10-32.	Entity estimation processes around stand-alone selling prices and any related controls are expected to comply with FASB ASC 606 and, in some cases, new processes and controls may need to be established. When estimating the stand-alone selling price, management may develop a process and related preparation and review controls and make maximum use of observable inputs, consistent application of the approach, and the consideration of market conditions and entity-specific factors. Because FASB ASC 606 requires maximizing the use of observable inputs, management will likely need to involve personnel beyond accounting and finance, such as those involved in pricing decisions. Documentation of the process and related controls would often be expected to be robust, especially if observable inputs are limited. Auditors relying on the entity's controls should test those controls in accordance with AU-C section 330. Auditors ordinarily will need to gather evidence regarding the entity's choice of the "best" inputs in its process.

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Five-Step Model	*Management Estimates That May Be Required*	*Audit Considerations*
Recognize revenue—satisfaction of performance obligations over time	The objective of measuring progress is to depict an entity's performance in transferring control of goods or services to the customer. A single method of measuring progress should be used over time and consistently applied to similar performance obligations. At the end of each reporting period, an entity shall remeasure its progress toward complete satisfaction of a performance obligation satisfied over time. Appropriate methods to make the measurement include input and output methods. Changes in the method adopted are not allowed and any changes in estimate related to the measurement of progress fall under FASB ASC 250. For a discussion of performance obligations satisfied over time, see paragraphs 27–29 and 31–35 of FASB ASC 606-10-25.	Because entities are required to re-measure progress toward complete satisfaction of a performance obligation satisfied over time at the end of each reporting period, judgment may often be needed to evaluate that these are truly changes in estimate and not errors. Management may develop controls (likely review and approval) for remeasuring progress along with robust documentation to support assumptions. Auditors relying on the entity's control should test those controls in accordance with AU-C section 330.

2.179 Other areas within FASB ASC 606 where estimation is likely include significant financing component, sale of products with a right of return, consideration payable to a customer, valuing noncash consideration, and nonrefundable upfront fees.

Potential Area of Focus—Management Bias

2.180 Management is in a unique position to incorporate bias or a lack of neutrality into the estimates they prepare as part of the revenue recognition process. Revenue is a financial statement area particularly susceptible to bias because revenue is an important determinant in many factors that influence employee matters like compensation and promotion considerations, operational matters like major production, decision-making and strategic direction, and overall financial performance matters like stock price and stakeholder perception. Additionally, FASB ASC 606 includes provisions that require management estimation, which provides management with the opportunity to inappropriately bias the estimation process.

2.181 Paragraph .21 of AU-C section 540 includes requirements for the auditor to "review the judgments and decisions made by management in the making of accounting estimates to identify whether indicators of possible management bias exist." The auditor can perform these procedures when obtaining an understanding of the inputs and assumptions used to create the estimate. This is an area in which the auditor needs to exercise professional skepticism and professional judgment because of the role of revenue as it relates to the reported income of the entity and the ability of management to influence the final balance through manipulation of the estimate.

Management Representations

2.182 Paragraph .10 of AU-C section 580 states that "the auditor should request management to provide a written representation that it has fulfilled its responsibility, as set out in the terms of the audit engagement, for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework" and "for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error."

2.183 Paragraph .20 of AU-C section 580 states that "the date of the written representations should be as of the date of the auditor's report on the financial statements." Such representations are part of the audit evidence the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion. Written representations from management complement other auditing procedures. Paragraph .04 of AU-C section 580 states

> [a]lthough written representations provide necessary audit evidence, they complement other auditing procedures and do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, obtaining reliable written representations does not affect the nature or extent of other audit procedures that the auditor applies to obtain audit evidence about the fulfillment of management's responsibilities or about specific assertions.

2.184 AU-C section 580 establishes requirements and provides guidance on the matters to which specific representations should relate, including the financial statements; completeness of information; recognition, measurement and disclosure; subsequent events; and audit adjustments. Examples of such representations that may be relevant to revenue recognition include representations that management has done the following:

- Disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud
- Disclosed to the auditor any relevant side agreements
- Disclosed to the auditor the identity of the entity's related parties and all the related-party relationships and transactions of which it is aware (for example, sales and amounts receivable from related parties) and has appropriately accounted for and disclosed such relationships and transactions
- Has provided the auditor with all relevant information and access, as agreed upon in the terms of the audit engagement

- Believes (or does not believe) that significant assumptions used in making accounting estimates are reasonable
- Believes (or does not believe) the effects of uncorrected misstatements are immaterial, individually and in the aggregate, to the financial statements as a whole. A summary of such items should be included in, or attached to, the written representation letter

2.185 It is important to tailor the representation letter to include additional appropriate representations from management relating to matters specific to the entity's business or industry. When the auditor determines that it is necessary to obtain representation concerning specific revenue recognition issues, the auditor should obtain written representations such as the terms and conditions of

- unusual or complex criteria included in contracts with customers.
- unusual or complex situations that qualify promised goods and services as distinct and therefore as separate performance obligations.
- significant estimates and assumptions used in determining amounts of variable consideration, including the constraint.

2.186 Management may be tempted to rely on various assumptions and for auditors to accept representations in lieu of the required evidential support for the financial amounts and disclosures when reporting deadlines approach. Timely discussions about the nature and extent of evidence that will be requested by the auditor to support management amounts and disclosures may mitigate this foreseeable situation.

Independence

2.187 Auditors should be mindful of the revised AICPA Code of Professional Conduct and, in particular, the "Scope and Applicability of Nonattest Services" interpretation under the "Independence Rule" (AICPA, *Professional Standards*, ET sec. 1.295.010) that explicitly defines financial statement presentation, cash to accrual conversions, and performing reconciliations as nonattest services. These services are assessed alone and in combination with other services when assessing overall auditor independence. The risk associated with failure to maintain independence can have serious consequences for auditors.

2.188 Over the years, many entities have looked to their auditors to directly assist them in understanding and complying with new accounting standards, such as FASB ASC 606. However, few previously issued accounting standards have had the effect of introducing the potential sweeping changes that FASB ASC 606 has. FASB ASC 606 challenges auditors and entities alike to look retrospectively and prospectively on the effects that these potential changes may bring to this critical financial statement area. Being mindful of the need to maintain independence when having conversations with management regarding FASB ASC 606 may avoid issues that could be troublesome for the auditor and the audited entity. However, both management and the auditor can benefit from understanding the process and the needs of the other party as early in the process as possible so that the entity's efforts create an efficient and auditable trail of evidence.

Consultation

2.189 Advance consultation on the approach management plans to use, for the first year of implementation and beyond, to comply with the recognition and disclosure requirements to recognize revenue is beneficial. Issues for discussion might include the following:

- Evidence of the completeness and accuracy of the data used in management's analysis
- The approach or model used to develop the first year amounts and disclosures
- Controls in place over the process of developing the first-year disclosures
- Controls to be in place to ensure proper revenue recognition going forward
- Consideration of any third-party consulting guidance provided to management. The relationship of a third party consultant to the entity may also require some analysis, as revenue recognition may not be viewed to involve a subject matter 'other than' accounting, and as such a consultant may not qualify as a "specialist" relationship. Can management effectively supervise and oversee the work of the consultant? Management may be fully responsible for the work product of the consultant.
- Selection and evaluation of any management assumptions underlying the analysis and the evidence supporting those assumptions. AU-C section 540 may often apply to the historical data analysis as well as to the periodic recognition of revenue.
- Important management representations likely to be required

2.190 These topical discussions between the auditor and the entity can be helpful in the early identification of complex issues that could arise as the implementation date of FASB ASC 606 draws closer. For example, if the data used to develop the initial transition balances or disclosures is not readily available for use in a convenient form or has not been tested for, among other things, completeness and accuracy, the entire analysis may need to be tested before it can be used. Timely consideration of this issue can avoid such issues.

2.191 An engagement performed by the independent auditor to directly convert or restate the treatment of past and current revenues in the period of transition may raise independence concerns. Thus, care is needed to define an auditor's role in resolving these management issues or performing any of the related analyses. Auditors may wish to articulate in their documentation why independence is <u>not</u> impaired by any client service related to implementing the new revenue recognition standard.

Situations in Which Auditors Can Assist During Transition

2.192 Provided management accepts responsibility and has the skills, knowledge, and experience to transition to and comply with the new revenue recognition standard, auditors operating under GAAS may be able to assist management with the transition. Following the basic guidance in AU-C section 230, *Audit Documentation* (AICPA, *Professional Standards*), it is recommended that the auditor document the basis of the assessment of the skills, knowledge, and experience of management in such cases. The auditor's assessment of these characteristics may be important in supporting the acceptability of his or her role. In the audit of a public company, the auditor's role may be even more restricted.

2.193 The "Scope and Applicability of Nonattest Services" interpretation became effective December 15, 2014. It is important to be alert for possible AICPA guidance or interpretations that may be issued to help clarify the principles of the application of the "Scope and Applicability of Nonattest Services" interpretation.

2.194 Auditors may wish to contemporaneously document any procedures performed in the assessment of management's skills, knowledge, and experience when management accepts responsibility for the work performed. AU-C section 230 provides broad guidance on documentation issues. Although the aforementioned "Scope and Applicability of Nonattest Services" interpretation does not identify unique documentation requirements, under *Government Auditing Standards* and some state rules (for example, California), a failure to document an activity creates a presumption that the activity was not performed.

2.195 It may be practical for some entities to engage a third party (for example, a consultant or other CPA firm) to assist them in making the required conversions in order to apply the provisions of FASB ASC 606. However, the engagement of third parties does not reduce management's responsibility for the transition or the auditor's responsibility to obtain sufficient appropriate audit evidence regarding the presented financial information and disclosures.

2.196 Public entities and auditors of public entities should consider the independence rules of the SEC and PCAOB before performing any services related to revenue recognition and compliance with FASB ASC 606.

Disclosures

2.197 When evaluating whether the financial statements include the required disclosures that contain the information necessary for the fair presentation of the financial statements, auditors may consider evidence related to

- management's process and controls over collecting any data needed for the disclosures in transition.
- a complete disclosure checklist prepared by management.
- an evaluation of the design effectiveness of the entity's financial statement close process, including the financial reporting controls over disclosures.

2.198 The evaluation of the disclosures may also include an evaluation of uncorrected misstatements and the potential impact of those uncorrected misstatements on the required disclosures.[56] The auditor may evaluate the impact of omitted or incomplete disclosures using qualitative considerations based on the nature of the transaction required to be disclosed. Disclosures addressing related-party transactions will likely require an evaluation based on the

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[56] Uncorrected misstatements are also relevant to the general topic of auditing revenues, but may take on a more complex character when applied to disclosures or applied in the context of the implementation of FASB ASC 606.

qualitative considerations of the transaction with the related party and the nature of the disclosures.[57]

Smaller Entities

2.199 FASB ASC 606 is a principles-based standard that applies to all entities, without regard to industry or entity size. That said, smaller entities may have simpler business models or more standard contracts compared to larger, more complex entities, making the transition and future accounting simpler. Smaller entities with fewer resources and more complex revenue recognition accounting issues, however, may need more outside consulting assistance to make the transition to FASB ASC 606. Academic resources, other accounting firms, and independent consultants may provide the needed assistance to smaller entities in accordance with independence rules. Smaller entities should exercise care in the selection of consulting resources to ensure their competence, objectivity, and the use of methods that will support auditor efforts to obtain evidence of fair presentation of the financial results, including the required disclosures.

Audit Documentation

2.200 Because revenue is a significant account in most financial statements, a benchmark from which relationships with other accounts are often made, and a presumed fraud risk, it receives considerable attention in the audit and peer review process. As such, documentation of the procedures performed, evidence examined, and conclusions reached regarding revenue amounts and disclosures is important, as described in paragraph .08 of AU-C section 230.

2.201 In light of the potential magnitude of change introduced by FASB ASC 606, care in the documentation of the audit procedures and evidence supporting the revenue balances and initial required disclosures is warranted.

2.202 AU-C section 230 is a principles-based auditing standard that applies to auditing procedures in all audit areas. The absence of specific audit documentation requirements in any part of an auditing standard simply means that the general documentation principles are expected to be applied. Some specific documentation requirements accompany selected auditing standards. Failure to document a procedure performed may lead to a presumption that the procedure was not performed. Under *Government Auditing Standards* and some state rules, failure to document a procedure leads to a rebuttable presumption that the procedure was *not* performed. Under AU-C section 230, an auditor can clarify or explain documentation, but an oral assertion regarding performance falls short of the documentation requirements, as described in paragraph .A7 of AU-C section 230.

2.203 Revenue recognition is a presumed fraud risk and significant risk area, as noted in paragraph .27 of AU-C section 240. The presence of fraud risk factors increases the expectation that the fraud risk presumption will likely apply. When the presumption does not apply, such as when revenue recognition is simple, audit documentation should explain the reasoning behind the

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[57] The point of assembling the disclosures may provide another opportunity to assess the adequacy of audit procedures in the current and prior periods that support the amounts and disclosures in these periods. Materiality judgments in the current and prior periods may change due to the implementation of FASB ASC 606.

exception to the presumption, as described in paragraph .46 of AU-C section 240.

2.204 If, in the process of auditing revenues or disclosures, inconsistencies between sources of evidence arise, the auditor should document how the inconsistency was addressed, as required in paragraph .12 of AU-C section 230.

2.205 Other auditing procedures involving revenue may be related through contemporaneous direct linkages or cross references to the revenue section of the work papers to show their relationship to the evidence regarding revenue recognition. For example, as described in paragraph .22 of AU-C section 240, revenue-related analytical procedures should be performed to detect risks of fraud (or error). Such procedures may include comparisons to production capacity, a comparison of sales to shipments, and a monthly trend line of sales and returns to detect fictitious sales or side agreements that would preclude revenue recognition, as described in paragraph .A26 of AU-C section 240. Paragraphs .A57–.A58 of AU-C section 240 explain that uncharacteristic sales patterns at year end can indicate misstated revenue, whether caused by error or fraud. Additional audit procedures that might be applicable to revenue are noted in appendix B of AU-C section 240.

2.206 Experience has shown that documentation deficiencies identified in peer reviews and inspections are common. Building excellent working practices for contemporaneous documentation and extensive cross references of risks, procedures addressing those risks, and conclusions can avoid many of these noted issues. Careful internal reviews can also contribute to reducing the source of these deficiencies. Such linkages have been shown to be difficult to reconstruct in periods after the audit is complete and time has passed.

Appendix A

Overview of Statements on Quality Control Standards

This appendix is nonauthoritative and is included for informational purposes only.

This appendix is a partial reproduction of chapter 1 of the AICPA practice aid *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, available at www.aicpa.org/interestareas/frc/pages/enhancingauditqualitypracticeaid.aspx.

This appendix highlights certain aspects of the quality control standards issued by the AICPA. If appropriate, readers should also refer to the quality control standards issued by the PCAOB, available at www.pcaobus.org/Standards/QC/Pages/default.aspx.

1.01 The objectives of a system of quality control are to provide a CPA firm with reasonable assurance[1] that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), addresses a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. That section is to be read in conjunction with the AICPA Code of Professional Conduct and other relevant ethical requirements.

1.02 A system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The nature, extent, and formality of a firm's quality control policies and procedures will depend on various factors such as the firm's size; the number and operating characteristics of its offices; the degree of authority allowed to, and the knowledge and experience possessed by, firm personnel; and the nature and complexity of the firm's practice.

Communication of Quality Control Policies and Procedures

1.03 The firm should communicate its quality control policies and procedures to its personnel. Most firms will find it appropriate to communicate their policies and procedures in writing and distribute them, or make them available electronically, to all professional personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

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[1] The term *reasonable assurance*, which is defined as a high, but not absolute, level of assurance, is used because absolute assurance cannot be attained. Paragraph .53 of QC section 10, *A Firm's System of Quality Control* (AICPA, *Professional Standards*), states, "Any system of quality control has inherent limitations that can reduce its effectiveness."

- A requirement for each individual to be familiar with and to comply with these policies and procedures

Effective communication also includes procedures for personnel to communicate their views or concerns on quality control matters to the firm's management.

Elements of a System of Quality Control

1.04 A firm must establish and maintain a system of quality control. The firm's system of quality control should include policies and procedures that address each of the following elements of quality control identified in paragraph .17 of QC section 10:

- Leadership responsibilities for quality within the firm (the "tone at the top")
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

1.05 The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, and policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

1.06 Policies and procedures established by the firm related to each element are designed to achieve reasonable assurance with respect to the purpose of that element. Deficiencies in policies and procedures for an element may result in not achieving reasonable assurance with respect to the purpose of that element; however, the system of quality control, as a whole, may still be effective in providing the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the firm or engagement partners issue reports that are appropriate in the circumstances.

1.07 If a firm merges, acquires, sells, or otherwise changes a portion of its practice, the surviving firm evaluates and, as necessary, revises, implements, and maintains firm-wide quality control policies and procedures that are appropriate for the changed circumstances.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

1.08 The purpose of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. The firm should establish and maintain the following policies and procedures to achieve this purpose:

- Require the firm's leadership (managing partner, board of managing partners, CEO, or equivalent) to assume ultimate responsibility for the firm's system of quality control.
- Provide the firm with reasonable assurance that personnel assigned operational responsibility for the firm's quality control system have sufficient and appropriate experience and ability to identify and understand quality control issues and develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

1.09 Establishing and maintaining the following policies and procedures assists firms in recognizing that the firm's business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs:

- Assign management responsibilities so that commercial considerations do not override the quality of the work performed.
- Design policies and procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.
- Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

Relevant Ethical Requirements

1.10 The purpose of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Require that personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office, and any other applicable regulators.
- Establish procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.
- Establish procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.
- Require that the firm withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.

- Require written confirmation, at least annually, of compliance with the firm's policies and procedures on independence from all firm personnel required to be independent by relevant requirements.
- Establish procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of the engagement. This would apply to national firm personnel, foreign firm personnel, and foreign-associated firms.[2]
- Require the rotation of personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.

Acceptance and Continuance of Client Relationships and Specific Engagements

1.11 The purpose of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- is competent to perform the engagement and has the capabilities, including the time and resources, to do so;
- can comply with legal and relevant ethical requirements;
- has considered the client's integrity and does not have information that would lead it to conclude that the client lacks integrity; and
- has reached an understanding with the client regarding the services to be performed.

1.12 This assurance should be obtained before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.[3]

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[2] A *foreign-associated firm* is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms.

[3] Such considerations would include the risk of providing professional services to significant clients or to other clients for which the practitioner's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a member or a firm refers to

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- Evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.
- Obtain an understanding, preferably in writing, with the client regarding the services to be performed.
- Establish procedures on continuing an engagement and the client relationship, including procedures for dealing with information that would have caused the firm to decline an engagement if the information had been available earlier.
- Require documentation of how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.

Human Resources

1.13 The purpose of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements, and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Establishing and maintaining policies such as the following assist the firm in obtaining this assurance:

- Recruit and hire personnel of integrity who possess the characteristics that enable them to perform competently.
- Determine capabilities and competencies required for an engagement, especially for the engagement partner, based on the characteristics of the particular client, industry, and kind of service being performed. Specific competencies necessary for an engagement partner are discussed in paragraph .A27 of QC section 10.
- Determine the capabilities and competencies possessed by personnel.
- Assign the responsibility for each engagement to an engagement partner.
- Assign personnel based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.
- Have personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to accomplish assigned responsibilities

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(footnote continued)

relationships that could diminish a practitioner's objectivity and independence in performing attest services. Examples of factors to consider in determining the significance of a client to an engagement partner, office, or practice unit include (*a*) the amount of time the partner, office, or practice unit devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which the partner, office, or practice unit is compensated, or (*d*) the effect that losing the client would have on the partner, office, or practice unit.

and satisfy applicable continuing professional education requirements of the AICPA, state boards of accountancy, and other regulators.

- Select for advancement only those individuals who have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

Engagement Performance

1.14 The purpose of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements, and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed.

1.15 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the engagement performance element of quality control:

- Plan all engagements to meet professional, regulatory, and the firm's requirements.
- Perform work and issue reports and other communications that meet professional, regulatory, and the firm's requirements.
- Require that work performed by other team members be reviewed by qualified engagement team members, which may include the engagement partner, on a timely basis.
- Require the engagement team to complete the assembly of final engagement files on a timely basis.
- Establish procedures to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.
- Require the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.
- Require that
    - — consultation take place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);
    - — sufficient and appropriate resources be available to enable appropriate consultation to take place;
    - — all the relevant facts known to the engagement team be provided to those consulted;

  - the nature, scope, and conclusions of such consultations be documented; and
  - the conclusions resulting from such consultations be implemented.
- Require that
  - differences of opinion be dealt with and resolved;
  - conclusions reached are documented and implemented; and
  - the report not be released until the matter is resolved.
- Require that
  - all engagements be evaluated against the criteria for determining whether an engagement quality control review should be performed;
  - an engagement quality control review be performed for all engagements that meet the criteria; and
  - the review be completed before the report is released.
- Establish procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.
- Establish criteria for the eligibility of engagement quality control reviewers.

Monitoring

1.16 The purpose of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports issued by the firm are appropriate in the circumstances

1.17 Establishing and maintaining policies such as the following assist the firm in obtaining the assurance required relating to the monitoring element of quality control:

- Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.

- Assign performance of the monitoring process to competent individuals.
- Require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures. Monitoring procedures consist of the following:
  - — Review of selected administrative and personnel records pertaining to the quality control elements.
  - — Review of engagement documentation, reports, and clients' financial statements.
  - — Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate that improvements are needed.
  - — Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
  - — Communication of the identified findings to appropriate firm management personnel.
  - — Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.
  - — Assessment of
    - the appropriateness of the firm's guidance materials and any practice aids;
    - new developments in professional standards and regulatory and legal requirements and how they are reflected in the firm's policies and procedures where appropriate;
    - compliance with policies and procedures on independence;
    - the effectiveness of continuing professional development, including training;
    - decisions related to acceptance and continuance of client relationships and specific engagements; and
    - firm personnel's understanding of the firm's quality control policies and procedures and implementation thereof.
- Communicate at least annually, to relevant engagement partners and other appropriate personnel, deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.

- Communicate the results of the monitoring of its quality control system process to relevant firm personnel at least annually.
- Establish procedures designed to provide the firm with reasonable assurance that it deals appropriately with the following:
    - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements.
    - Allegations of noncompliance with the firm's system of quality control.
    - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations.

      This includes establishing clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisal and documenting complaints and allegations and the responses to them.
- Require appropriate documentation to provide evidence of the operation of each element of its system of quality control. The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following, for example:
    - The size of the firm and the number of offices.
    - The nature and complexity of the firm's practice and organization.
- Require retention of documentation providing evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

1.18 Some of the monitoring procedures discussed in the previous list may be accomplished through the performance of the following:

- Engagement quality control review
- Review of engagement documentation, reports, and clients' financial statements for selected engagements after the report release date
- Inspection[4] procedures

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[4] *Inspection* is a retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them. Although monitoring procedures are meant to be ongoing, they may include inspection procedures performed at a fixed point in time. Monitoring is a broad concept; inspection is one specific type of monitoring procedure.

Documentation of Quality Control Policies and Procedures

1.19 The firm should document each element of its system of quality control. The extent of the documentation will depend on the size, structure, and nature of the firm's practice. Documentation may be as simple as a checklist of the firm's policies and procedures or as extensive as practice manuals.

